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PERFORMANCE THROUGH INNOVATION

BARCLAYS GLOBAL INVESTORS

May 27, 2002

John Stevenson, Secretary
Ontario Securities Commission
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Toronto, ON M5H 3S8

- and -

Denise Brousseau, Secretary
Commission des valeurs mobiliéres du Québec
800 Victoria Square, Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Québec H4Z 1G3

Dear Sir and Madam,

Re: Request for Comments: Concept Proposal 81-402 – Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers

We at Barclays Global Investors Canada Limited (BGI) thank you for your invitation to comment on Concept Proposal 81- 402 (the "Proposal"). We are strong believers in the value of meaningful dialogue between regulators and industry participants and commend the Canadian Securities Administrators for the thorough public consultation they have undertaken in connection with the Proposal.

BGI, which currently manages over $40 billion in assets, is one of Canada's largest and fastest growing investment managers. We are not the manager of any traditional mutual funds but do manage the iUnits family of exchange-traded funds and use non-prospectused mutual funds ("pooled funds") to a fairly significant extent in our core business of providing investment advisory services to Canadian pension funds and other institutional investors. BGI is part of a global investment management business that manages over a trillion dollars in assets and we therefore have very broad experience in regulatory approaches applied to this industry, including mutual fund governance regimes. While we have an interest in the impact the Proposal may have on the Canadian mutual fund industry as a whole, our comments will primarily focus on the potential impact of the Proposal on exchange traded funds (ETF's) and pooled funds.

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Before turning to our specific comments on the Proposal and our responses to certain of the questions asked in the Proposal, we address four more general issues that are related to the Proposal and that we believe need to be taken into consideration as part of any thorough analysis of the Proposal.

GENERAL COMMENTS

1. The Proper Role of Regulation

We believe that regulation is only appropriate when (i) there is an asymmetry of information between market participants (most commonly between investors and other market participants) and necessary information can be made available most efficiently through the establishment of regulatory “ground rules” or (ii) conflicts of interest exist. We believe that both of these criteria are met in certain areas of Canada’s mutual fund industry and that the CSA has a very important role to play in the proper functioning of the industry. However, the areas in which either of these criteria apply are fairly limited, particularly for certain types of mutual funds and, where the latter criterion applies, prescriptive regulation is often a less efficient regulatory approach than an “independent governance” approach as contemplated by the Proposal.

We understand that a number of major securities regulatory initiatives are underway concurrently with consideration of the Proposal, including a Uniform Securities Act project, the B.C. Deregulation Project, the O.S.C.’s Reregulation of Advice or “Fair Dealing” project, the CSA’s consideration of the regulation of various non-mutual fund collective investment products and the Capital Accumulation Plan Project of the Joint Forum of Financial Market Regulators. In addition, the 5-Year Review of Ontario Securities Regulation has recently resulted in a further set of proposals to amend Ontario’s securities regulatory regime. We are strongly supportive of these projects, as we believe that much of Canada’s securities regulatory regime is dated, inflexible and/or unnecessary. Coordination of these many projects and proposals is essential however and any effective coordination will require a consistent basis of analysis. We strongly urge you to work with the participants in these other projects and to apply the criteria set out above when considering whether current or proposed regulation is appropriate. Where neither of the criteria is met, the simple answer is “no regulation”.

2. Deregulation

As noted above, we believe that certain aspects of the current regulatory regime applicable to mutual funds are either unnecessary or could be more efficiently and effectively carried out through a governance approach rather than the current prescriptive approach. We address the latter issues in more detail below but feel very strongly that the former issues should be considered in their own right and not simply as a potential *quid pro quo* for a new governance agency regime. We recommend below that as an alternative to the Proposal as structured, the CSA increase the scope of the Proposal to include an examination of whether there are aspects of the current regulatory regime which are simply unnecessary across the industry or in respect of certain industry sectors. Regardless of whether this recommendation is adopted however, it is essential to undertake this analysis in some forum.

As discussed below, the B.C. Securities Commission has, we believe appropriately, questioned in its Deregulation Paper whether an independent governance agency is really necessary as an alternative to the existing prescriptive regime. In our view, where neither of the criteria above is satisfied, the CSA should simply eliminate existing regulation rather than replacing it with an alternative form of regulation. Areas in which the CSA members should ask themselves whether any form of regulation is necessary might include inter-fund trading, cross trading and a number of current investment restrictions. If, in respect of mutual funds in general or certain types of funds, it is concluded that neither of the criteria apply, the regulation should simply be abandoned. For example, as discussed in detail below, many of the circumstances within the traditional mutual fund industry in which one or both of the criteria justifying regulation are satisfied simply do not arise in the case of ETF’s. In cases such as this there is simply no basis for regulation of any type.

3. The Need for a National Approach

While the regulatory regime governing mutual funds is largely carried out through a national regime, it is still implemented by a fragmented, inefficient and costly structure. Discrepancies remain in certain of the statutory rules applicable to mutual funds such as the registration requirements necessary in Ontario and Newfoundland to distribute mutual funds to investors in the exempt market, fees payable in each jurisdiction in connection with renewal prospectuses, the differing deadlines for the filing of renewal prospectuses and the investment and other rules applicable to pooled funds in Quebec. Along with the myriad of other inconsistencies, this leads to an unnecessarily costly and inefficient compliance burden upon industry. We are strongly supportive of the implementation of a Uniform Securities Act and caution the CSA of the possible danger of moving too far with the Proposal before the basics of a Uniform Act are determined as an important part of the latter should be the consideration referred to above of eliminating much existing regulation. The Proposal and the Uniform Act project will be ineffective if not fully coordinated and if not complimented by uniformity of regulation and local policies.

Even if all of the foregoing is accomplished however, of all of the jurisdictions around the world in which BGI does business, Canada will remain what is probably the most complicated and costly from a regulatory perspective. <u>The single most important issue that should be addressed by the CSA and by Canadian politicians, and one which should not be postponed because of other projects, is the implementation of a national securities regulator</u>. Until Canadian securities market participants are able to deal with one regulatory body that consistently applies a consistent regime, Canadian investors and the

Canadian economy will continue to suffer from the unnecessary cost and inefficiencies that characterize the existing regulatory structure.

4. The Need for Details.

We appreciate the manner in which the Proposal was released – particularly the public consultation that has taken place, the plain language approach, the supporting documentation and the setting out of specific questions. The 39 questions asked in the Proposal are directed to what we believe are the most important issues raised and the format of the Proposal facilitates a structured response to these issues. The one shortcoming of the Proposal is the lack of many important details that are necessary to properly address the questions it raises. The Concept Proposal is essentially a very high level overview and, while we are pleased to take the opportunity to comment at this time, we urge the CSA to remain open to serious consideration of all aspects of the Proposal as more details are identified. What may currently appear innocuous or appropriate may not be so when elucidated by further detail. Similarly, concerns we identify in this submission may be alleviated once further details are made available. Our concern is that the CSA might move from the Proposal to a Draft National Instrument, a stage in the regulatory process at which, in our experience, the general structure of an initiative is very difficult to change. In light of the very high level of the Proposal, it is important for the CSA to remain open to significant changes at the next stage of the process as more details become available.

SPECIFIC COMMENTS

In this section we provide BGI's answers to certain of the specific questions asked in the Proposal. First, we address the two questions that are most important to BGI, and then we turn to a number (though not all) of the other questions.

1. Issues of Primary Importance to BGI

<u>Question 02:</u> *After reading the staff research paper and the text above, what is your opinion about the alternatives to our proposed approach? If you believe we should not change the status quo, please explain why. If you favour one or more of the alternatives we set out, please explain why. Are their other alternatives that we should consider?*

We recognize that the Proposal was released prior to the release by the British Columbia Securities Commission of its Deregulation Paper, and there are some parts of the BC Paper with which we have some concern, but the CSA should nonetheless seriously consider the BC Paper's discussion of mutual fund regulation and the questions raised by the B.C. Securities Commission in respect of the Proposal. It is clear that a shift from the current level of "prescriptive" regulation to a more flexible approach is clearly desirable to all industry participants. The Proposal assumes however that (apart from a "voluntary" industry approach similar to the existing corporate governance regime that we do not believe would be effective in the mutual fund context) the only choices are between the existing "prescriptive" regime and an alternative that introduces a new oversight mechanism (be it the proposed governance body, an alternative governance body or the funds' auditors). We believe the B.C. Securities Commission raises a legitimate question when it asks whether this type of oversight need accompany a relaxation of the existing prescriptive regime.

As noted in our general comments above, we believe that the various projects currently underway by Canada's securities and other financial services regulators need to be carefully coordinated if they are not to result in an even further fragmentation of an already inefficient system. We have suggested that regulation is appropriate only in certain circumstances and that those circumstances form a basis for the consideration of all new regulatory initiatives in order to ensure at least a base level of consistency. As it is consistent with this basic position, we believe that the B.C. Securities Commission is right to ask whether there are not certain aspects of the current regulatory regime that can be eliminated regardless of the ultimate fate of the Proposal.

The answer to B.C. Securities Commission's question is yes and we urge the CSA to expand the scope of the Proposal to include an analysis of this question. The Proposal should address not only whether a governance approach to regulation is appropriate but also whether there are areas where no regulation is needed at all. There is not any substantive reason to separate the analysis of these two issues and doing so would simply lead to unnecessary duplication of regulatory and industry effort. Rather than create yet another project or leave the B.C. Securities Commission alone considering this question, we urge you to incorporate this analysis into your work on the Proposal and not to start the analysis with the premise that all aspects of the current regime are necessary and the only necessary analysis is whether "prescription" or "governance" is the preferable approach.

In the Proposal, the CSA is asking whether fund governance, manager registration and certain other regulatory initiatives are appropriate. This scope is too limited and the CSA should, at the same time, be asking whether all other components of the mutual fund regulatory regime are appropriate. The historic consideration of mutual fund regulation on a piecemeal basis has resulted in the existing overly restrictive regime in which costly and time consuming exemptive relief is commonly sought and granted in a number of areas and in which change takes years at best. We urge the CSA to expand the scope of the Proposal to consider all aspects of mutual fund regulation to avoid continuing this unfortunate and costly approach to regulation. Elsewhere in this submission we identify certain areas where we believe the elimination of existing prescriptive regimes is appropriate in the absence of a fund governance regime.

Question 04: *"Which parts of our renewed regulatory framework should be extended or not extended to other investment vehicles – and which investment vehicles. Why do you* *believe the particular regulation should or should not be extended? What is the essential difference – or similarity – between the particular investment vehicles that mean they should be regulated differently or the same?"*

Answer: As noted above, one of the most important questions for us that is raised by the Proposal is how it will impact exchange-traded funds and pooled funds. We address each of these products in turn.

(a) Exchange-Traded Funds

As by far the largest sponsor and provider of exchange traded funds in Canada, we continue to be encouraged by the CSA's desire to better understand these products and their differences from traditional mutual funds. As discussed with staff at various of the Canadian securities regulatory authorities, there are a number of significant differences between traditional mutual funds and ETF's that need to be considered in determining how best to regulate these funds. These differences include the following:

- *Costs*. The fees charged to ETF's are generally significantly lower than the fees charged by traditional retail mutual funds. This reflects, amongst other things, the absence of any compensation by the manager to dealers and the reliance upon the TSX exchange mechanism rather than the traditional mutual fund issuance and redemption mechanism. Stock exchanges, by focusing buying and selling interest for a given security on a single place and time, maximize the probability that the other side of a trade will be found at a competitive price thereby offering an efficient means for buying and selling securities. This is a much more efficient mechanism than the issuance and redemption process utilized by traditional mutual funds. There is nothing inherent to mutual funds that distinguish them from a traditional equity security for this purpose and relying upon this efficient trading mechanism is one of the most significant benefits offered by ETF's. In addition, reliance upon the exchange trading process brings with it other efficiency benefits such as the existing client reporting facilities and processes of independent dealers and reliance upon the clearing and settlement services of CDS.

  The Proposal could significantly impact the current cost structure of ETF's and, quite literally, undermine the value of the product as currently structured. Even if the 16 bps. cost estimate across all funds contained in the Proposal is accurate (and given the significant lack of detail on many of the issues that will be determinative of cost we're concerned it may underestimate the true cost), it must be recognized that the true cost to different types of funds will be different and the impact on managers of different types of products will also be different. In the case of BGI's ETF's for example, passing this cost along to the iUnits S&P/TSE 60 Index Participation Fund (by far the largest ETF in Canada) would almost double the expenses incurred by investors as the total fees payable by that ETF are currently limited to 17 bp. We do not believe that investors would see the adoption of the Proposal as adding sufficient value to double the costs incurred by the fund. ETF's have a strong track record in Canada, starting in 1989 and the very low fee structure has been an important part of this success. The proportionate impact of this level of fee increase on ETF's as compared to other products is unjustifiable.

- *Investment approach* – ETF's generally have limited, if any, investment discretion. They are designed to track as closely as possible the underlying benchmark. There is no ability to purchase or sell securities for considerations other than that they must be purchased or sold so that the fund's portfolio accurately reflects the underling benchmark. As noted above, portfolio transparency is a key component of an ETF as it is necessary to ensure the tracking feature of these products. This transparency can only exist where the ETF is based on an underlying index or is subject to an explicit "index-like" portfolio rules. A true ETF cannot succeed if it is not managed in this way. As a result, a number of the prohibitions and restrictions on related-party transactions and the investment constraints are not necessary in connection with ETF's. Similarly, there would be no value added by requiring a governance agency to oversee these portfolio transactions. We would urge the CSA to consider this issue and to consider whether the same analysis might also apply to many traditional index mutual funds.

- *Distribution structure* – There is no "principal distributor" for our ETF's as there is for traditional mutual funds and they are not distributed primarily through the traditional mutual fund dealer network. Instead, the iUnits funds are distributed through a more traditional underwriting structure in which unrelated, leading Investment Dealer Association member firms, subscribe for units and then sell those units to investors. Neither the funds nor BGI as manager pay any amounts to dealers in respect of any transactions between the dealer and its clients. For example, no trail commission is paid to dealers based on their clients' holdings of our ETF's. Dealer compensation in the case of ETF's is entirely transparent and agreed upon between the client and his or her dealer with no involvement by BGI or the funds.

  As a result, the policy concern underlying the traditional mutual fund distribution structure, that investors may not be sufficiently aware of the manner in which their dealer or advisor is being compensated by the mutual fund complexes, part of which is ultimately paid out of the management fee received by the manager, does not exist for our ETF's. As a result, neither the "asymmetry of information" nor the "conflict of interest" rationale for regulation applies to the ETF distribution structure.

- *Liquidity and Transparency*. In purchasing or disposing of units of a traditional mutual fund, the individual investor is essentially dealing with the fund itself. The fund issues units on a subscription and redeems the units on a redemption. In the case of ETF's, almost all purchases and sales take place in the secondary market so that the investor is dealing only with his or her dealer and the investor on the other side of the trade with no involvement by the fund. Since the introduction of the world's first ETF's, the TIPS products, by the TSX in 1989, we understand that there has not been a single retail investor that "redeemed" units rather than selling them on the exchange. The arbitrage mechanism that constitutes an important part of the ETF product structure ensures that these secondary market trades take place at an amount that is very close to the fund's net asset value per unit.

In the case of traditional mutual funds, investors that wish to sell their fund units are entirely reliant upon the fund manager's ability to pay redemption proceeds. Additionally, portfolios of traditional mutual funds are often far from transparent and investors cannot judge for themselves the liquidity of the portfolio. For this reason, the liquidity of a mutual fund's portfolio has historically been a key focus of regulation. Where a fund's portfolio is not transparent and information about that portfolio and its liquidity is available to investors only on a significantly delayed basis, there is clearly an asymmetry of information and regulation is appropriate.

In the case of ETF's, investors do not depend upon the fund manager to pay them redemption proceeds when they wish to sell their fund units, they simply sell units on the relevant exchange at a market price that very closely tracks the fund's net asset value. This tracking is a key feature of ETF's without which they would be much less attractive investment alternatives. Portfolio transparency and liquidity are essential to the arbitrage mechanism that ensures this tracking. An ETF's portfolio is not "hidden" from investors until the semi-annual or annual financial statements are filed. An ETF's portfolio is fully transparent and available to investors at all times. Without this transparency and liquidity, investors would still be able to dispose of their units in the secondary market, but the close tracking between market price and NAV would be lost and with it the value proposition offered by ETF's. As a result, ETF managers have an externally imposed reason for ensuring liquid, transparent portfolios and the need to regulate liquidity is less important. Further, there is no asymmetry of information in this case so the justification for regulation does not exist. It is also worth noting that the exchanges on which ETF's trade, such as the TSX, have their own liquidity requirements that ETF's must meet like any other issuers and which provide an additional level of protection.

For all of these reasons, we do not believe that the Proposal should apply to Canadian ETF's. If many of the existing, unnecessary, prescriptive rules that currently apply to ETF's are not simply eliminated however, it may make sense for certain ETF's to adopt a governance structure if it is an alternative to these prescriptive rules. Other ETF groups may determine however that it is more cost effective to continue to comply with the existing prescriptive regime. Given the absence of a policy basis for many of the concerns identified by the CSA as underlying either prescriptive or governance based regulation and the potentially significant impact of the cost of adopting a governance structure however, we strongly urge the CSA to make adoption of a governance agency optional for ETF's in any event.

(b) Pooled Funds

As investment advisors to a significant number of institutional investors in Canada, we commonly utilize Pooled Funds as a result of the investment efficiencies offered by such vehicles. While we will always manage assets for clients on a "separate account" basis, we believe that pooling assets is beneficial to most clients and only through pooling are our services cost effective for many of our smaller clients. We believe that there is a fundamentally different nature to this aspect of our business and that the Proposal should not be applied to pooled funds used by investment managers in providing investment advisory services to institutional clients.

As discretionary investment managers for our clients, we have a direct advisory role with them and we utilize pooled investment trusts only where appropriate to the relationship and only as a means of implementing the relationship in the manner most beneficial to the client. The use of such funds is always subject to our direct fiduciary obligation to our client. We contrast this model with the "product" model underlying the traditional mutual fund industry in which the fund manager, most often, has no such direct relationship with the mutual fund investor. This distinction is evidenced by the detailed investment management agreements we negotiate with each client which formalize the relationship. Other differences between the retail mutual fund business and our own include:

- The sophistication of our clients and their use of consultants in selecting investment managers. There is almost never an asymmetry of information between our clients and us so that basis for recognition is essentially inapplicable in connection with our use of pooled funds. In B.C., Alberta and Ontario, recent regulatory changes have made it clearer than ever that regulatory "ground rules" are not the most efficient approach to ensuring appropriate levels of knowledge for these types of "accredited investors".
- The proficiency, capital, record keeping and other requirements to which we are already subject as registered advisors. Fund managers that are not registered as advisers are not subject to these types of requirements and we agree that at some basic requirements for fund managers may be appropriate. We urge you to ensure that there is no duplication or additional cost for registered advisers acting as fund managers.
- The level and transparent nature of the fees charged to clients in our business. The fees we charge our clients are significantly lower than the fees associated with the retail mutual fund industry. For example, if the 16 bp estimate of the cost of implementing the Proposal is accurate, passing it along to our clients would, in many cases, more than double the costs they currently incur. This is clearly not something they will accept. Further, our fees are fully disclosed in our client agreements and are commonly the subject of negotiation. As noted above in our

discussion of ETF's, the fees inherent in the traditional mutual fund structure are seen by some as not being transparent, particularly the dealer compensation structure. Our fee arrangements with clients invested in pooled funds are entirely transparent.

- The different "scale" of the business. We manage more than $40 billion in assets for approximately 160 clients whereas most retail mutual funds managing a similar level of assets have hundreds of thousands of investors. This is further evidence of the more symmetrical relationship we have with our clients as compared with the product manufacturing relationship the traditional mutual fund industry has with its investors.
- As noted above, under the existing regulatory regime, we, and through us the pooled funds we manage, are regulated through the "advisor" registration process. This accurately reflects the reality of our core business (as described above) and does not impose an artificial "product" perspective upon our business. This is another area in which existing regulation applies to a situation in which neither of the criteria justifying regulation exist and we encourage the CSA to simply remove pooled funds managed by registered advisers for use in providing services to accredited investors from "product" regulation of any sort. We are encouraged by the OSC's decision to review the applicability of 45-501 to pooled funds utilized by investment advisors and we strongly encourage the CSA to rely exclusively upon the adviser registration based approach to regulation where, as in the case of our business, that most accurately reflects the underlying relationship with clients.

  One area in which our business is developing that does not fit this model as fully is our growing business with institutions offering clients defined contribution savings plans. This aspect of our business is a "middle ground" between our core business and the traditional retail mutual fund business. It is an area in which our business more closely resembles that of traditional retail mutual fund managers and their business more closely resembles our traditional institutional investment management business. We are encouraged that the Joint Forum of Financial Market Regulators is looking at this area and we encourage the CSA to await the outcome of the Joint Forum's work before introducing an entirely new area of regulation to this part of the industry.

Consistent with these differences between the retail mutual fund industry and our investment advisory business, we do not believe that it is appropriate to expand the Proposal to pooled funds. We would note however that for at least two reasons, certain investment advisors might nonetheless decide to adopt a governance mechanism.

- First, even if the CSA agrees to await the work of the Joint Forum on capital accumulation plans, many pooled fund managers currently compete with traditional mutual fund managers in this market segment and if the Proposal is applied to the funds offered to the capital accumulation market by these managers, pooled fund managers may, for competitive reasons choose to adopt a fund governance mechanism (where the cost is justifiable).

- Second, were relief from certain existing regulatory restrictions to be available to investment advisors if their pooled funds or accounts were subject to the adoption of a governance mechanism, the costs saved might, in some cases, justify the introduction of a governance mechanism. While the provisions of NI 81-102 generally do not apply in our business we are subject to a variety of "conflict of interest" and "related party" regulations that give rise to significant costs to our clients. Where the criteria discussed above that justify regulation do not exist, these regulations should simply be eliminated. If the CSA does not see fit to take that step immediately however and only agrees to their elimination as a *quid pro quo* to the introduction of a governance mechanism, certain pooled fund managers may find that as a cost-benefit question, the introduction of a governance regime is appropriate.

As is the case with ETF's therefore, certain pooled fund managers may have reasons to adopt a governance mechanism for part or all of their pooled funds. Here again, we do not believe that a governance agency is justified as a matter of policy however and we strongly encourage you to make this a discretionary choice for pooled fund managers.

2. <u>Responses to Specific Questions</u>

<u>*Question 01:*</u> *We see our renewed framework for regulating mutual funds as a step towards a more flexible regulatory approach, one that represents a movement away from detailed and prescriptive regulation. By streamlining our regulation, we want to create a regulatory regime that can accommodate changes within the industry and keep pace with changes in other segments of the market and global market places. What are your views on our renewed framework? Will it represent an improvement over our current model?*

We believe that the renewed framework is definitely an improvement and that a move away from the current level of "prescriptive" regulation is a very significant development with application across the mutual fund industry. We have four suggestions however as to how to improve the likelihood that the Proposal will lead to an improved regulatory model.

First, as noted above, the Proposal asks too narrow a question and as a result the improvement it offers is significantly less than could be achieved through the broader analysis we recommend earlier in this submission. A new model that results from the consideration of whether regulation is needed at all in each area of the mutual fund industry as well as from a consideration of which model best addresses those areas that do need regulation would be an even more significant improvement than what can be expected from the Proposal as currently structured.

Second, we note that the Proposal does not directly address the potential for relying on improved disclosure as an alternative to prescriptive regulation or governance. We submit that the CSA should consider whether some or all of the objectives of the Proposal could not be achieved through improved disclosure. Where it is determined that regulation is appropriate, certain activities that are now prohibited or subject to quantitative limitation might be equally as effectively addressed in this manner without giving rise the inflexibility of the current model or the additional cost of a governance approach. Disclosure on its own might not provide as much flexibility on reducing prescriptive regulation as fund governance but a comparison of the costs and benefits with those of the Proposal may be appropriate.

Third, we strongly believe that certain aspects of regulation are most appropriately addressed through prescriptive restrictions and not all such regulation can be replaced through "guidelines" or "governance oversight". This is particularly true in those situations where the need for regulation arises as a result of an asymmetry of information. Often the most cost-effective and efficient manner of addressing this type of issue may be through the establishment of regulatory "ground-rules" which act as base "assumptions" for consumers and free them from the task of identifying how an issue is addressed by each individual fund organization.

Finally, the Proposal does not address one very important specific issue – sales practices and disclosure. The introduction of the new Simplified Prospectus regime has, we believe, significantly improved the utility of those documents to investors but there remains a significant need for better point of sale disclosure as to the investors "deal". There is a tremendous need for better transparency as to the mutual fund industry's compensation structure and exactly "who is getting what" of the investor's money. This is an area in which it can be argued that an asymmetry of information exists and the appropriate regulatory response to this fact should be considered. It would be consistent with what little we understand about the OSC's "Fair Dealing" project to ensure that it is absolutely clear to investors how the individual advising them to make an investment is being compensated if such compensation involves anything other than strictly a commission or fee negotiated between the investor and their adviser.

<u>Question 05:</u> *Although we do not address the fifth pillar of our proposed framework, we invite you to give us your ideas on how we could better carry out our role as regulator.*

We believe that an enhanced regulatory presence is very important. We note that most CSA members have increased significantly their on site audits of registered advisors and believe that a similar approach should be taken with registered mutual fund managers.

<u>Question 11:</u> *We do not currently propose to specify the maximum number of mutual funds that may be overseen by a governance agency. Is there a practical limit to the number of mutual funds that one governance agency can oversee effectively? Are mutual funds managed in ways that are sufficiently common to all mutual funds so that one governance agency can oversee all mutual funds in a related family? Should we provide guidance to the industry on the scope of oversight for a governance agency?*

As with respect to other items discussed below, this will depend upon the final scope of the agency's responsibility. At a very high level, all funds are managed in ways that are sufficiently common to all mutual funds so that one governance agency can oversee all mutual funds in a related family. If the regime is expanded beyond the traditional retail mutual fund industry however, this may no longer be the case. Further, if the responsibilities become too detailed (see discussion below with respect to the scope of the agency's responsibilities) it may become necessary to have different agencies for different types of funds based upon investment strategy, distribution mechanism or some other factor.

<u>Question 12</u>; *Do you think fund families will find it difficult to recruit qualified members for a governance agency at a reasonable cost? Do you have any experience with trying to recruit members of a governance agency?*

This again will depend upon the scope of the members' responsibilities, the extent of their potential liability and the number of agencies ultimately established as a result of the

Proposal. There is a small possibility that it could be difficult to recruit qualified members at a reasonable cost for the reasons noted below but given the lack of any significant detail as to the actual scope of the members' responsibilities this is a question that cannot be accurately answered at this point. In this respect, we note that the reasonability of this cost is relative and, in the context of an ETF with a maximum management expense ratio of 17 bps, 16 bps is clearly not a "reasonable" cost.

<u>Question 13:</u> *Does the definition of independent members make sense to you? Will it be easy to apply to potential governance agency members? If not, can you suggest an alternate definition or the clarifications you think are necessary? What do you think about whether or not we should require a majority or all members to be independent?*

The definition does make sense but we expect that in practice the applicability of the "or could reasonably be perceived to" component of the definition may lead to uncertainty and potential, after the fact, claims against a manager even if there was no "actual" conflict.

<u>Question 14:</u> *Are the responsibilities we describe appropriate for a governance agency? If not, please explain why. Have we neglected to mention any responsibilities that should be ascribed to the governance agency? For example, should the governance agency review or approve mutual fund disclosure documents?*

In addition to the comment we have already made about the Proposal not containing sufficient detail as to the actual responsibilities of members, we have two concerns with the responsibilities as described in the Proposal.

First, we are concerned that the requirement that the agency "consider and approve the fund manager's choice of benchmarks against which fund performance will be measured and monitor fund performance against these benchmarks" may require a level of knowledge that will significantly limit the scope of potential agency members. It may also require portfolio managers to spend an inappropriate amount of their time explaining "performance" to agency members. On the other hand, performance is obviously a key concern for investors and if there were one area in which they could be assumed to want their interests protected, it would likely be performance (though it is not clear what actual "protection" will be afforded by this oversight).

Second, we believe it is necessary that the scope of the Manager's responsibility to investors be clearly identified. We are concerned that the existing legal regime leaves it unclear as to the scope of the manager's obligations and, in particular, whether the "best interest" of the fund and its investors is the "best economic interest" or something more than that. In the absence of the introduction in Canada of a pure "business trust" concept, it is left to securities regulators to address this issue and there should be a default provision in securities regulation that the manager's responsibility is to act in the "best economic interest" of the fund. If a manager wishes to offer a fund with an alternative focus, this should be explicitly disclosed (possibly as a risk factor) and the governance agency should be charged with ensuring that the manager in fact follows this alternative focus.

Question 15: *Can you think of any other policies and procedures the governance agency should review and approve? For example, should the governance agency review policies on the use of derivatives?*

Other than potentially with respect to the "best interests of the fund" issue identified in our response to Question 14, we do not believe there are any additional policies or procedures that should be reviewed and or approved by the agency. We strongly disagree with the idea of having the governance agency review policies on the use of derivatives. The use of derivatives is a straightforward portfolio management question and requiring the agency to review a policy such as this would be moving into an area of far too much detail and could potentially scare off potential members. The governance agency's role should be to ensure that management has adopted policies; it should not be required to approve these policies.

Question 17: *The Fund Governance Committee of The Investment Funds Institute of Canada (IFIC) recommends that we limit the liability of a governance agency member for breaches of the standard of care to $1 million. In part because members of boards of directors of corporate mutual funds will not have this limitation on their liability we do not propose to regulate any limits on liability. Also, we are not convinced such a limitation is in the public interest. What are your views?*

In most circumstances, we agree with IFIC that it is appropriate to limit the liability of a governance agency member for breaches of the standard of care. Notwithstanding the potential availability of insurance, unlimited liability for all breaches of the standard of care would very likely put a chill on the willingness of individuals to serve on these governance agencies. Canadian courts have adopted a "business judgment rule" and it could be argued that this should give any responsible governance agency member sufficient comfort. We would note however that the Proposal is introducing a brand new type of governance in respect of which there is no past practice upon which a governance agency member could base a consideration as to what is required to meet his or her standard of care. Further, we do not believe that the precedent of mutual fund corporations is determinative of whether liability limits are appropriate or not, particularly for this reason.

Where the claim of a breach of the standard of care accompanies a conflict of interest or self-dealing on the part of the governance agency member however we agree that no limit on liability should apply. In this circumstance any reasonable governance agency member should realize that his or her activities are questionable and should be expected to be held to a higher level of responsibility. It is difficult to contemplate a circumstance in which an independent director would find him or herself in such a situation so the absence of a limit in these circumstances would be unlikely to put a "chill" on individuals assuming these independent member roles but it would make an agency member engaged in this type of egregious situation fully liable which we believe is appropriate.

<u>Question 26:</u>   What information do you think investors should receive about the governance agency in addition to, or in substitution for, the information we outline?

We believe the CSA has appropriately identified the type of information that should be provided by the manager on an annual basis. The proposal with respect to disclosure in a point of sale document however strikes us as likely to be ineffective. While a mutual fund investor may very well want to know of the existence of a governance agency (and potentially its role) and be assured of its independence, requiring disclosure of the name and background of each member at the point of sale is, in our view, more than most investors would want and would simply lead to additional, unnecessary cost

<u>Question 30:</u>   The Fund Governance Committee of IFIC recommends that the fund governance agency be responsible for considering the qualifications and proficiency of management. If the governance agency does not believe the fund manager has the right people to undertake the task of managing the funds, it should require changes. If the fund governance agency has this power, the Committee submits that we do not need to impose regulatory standards.

We do not agree with the assertion that the fund governance agency should take on this role. Our registration system for advisers and dealers sets out standards for their officers and directors and we think similar requirements should apply to fund managers. We think the governance agency should be responsible for overseeing the management of mutual funds, not for assessing the adequacy of senior management and the directors of the fund manager. Do you have any thoughts on this matter?

We agree with the CSA that it is appropriate to implement minimum proficiency requirements and that the regulator rather than the governance agency be responsible for considering the qualifications and proficiency of management is appropriate and that the analogy to the existing regime for advisors and dealers is appropriate. We understand IFIC's position but are concerned that this again would lead to agencies becoming involved in too much detail (how does the PDO compare to IFIC's OPD course?). Further, on baseline proficiency, we believe it is appropriate to have industry standards so that investors know that regardless of the views and/or knowledge of a particular governance agency, they can be assured of a minimum level of proficiency. This is consistent with the first of our two "justifications" for regulation. It is more efficient for mutual fund investors to be able to assume this base level of proficiency than to be required to determine the standards of proficiency that have satisfied various governance agencies and then compare those different standards. Certain fund groups may in fact decide to go beyond the regulatory requirements for competitive reasons and implement a "continuing education" requirement the contents of which could be subject to oversight by the agency. This is a separate question however and the "gatekeeper" role should remain with the regulator.

Please contact the undersigned or Warren Collier, Counsel (416-643-4075) for further explanation or clarification of any of the points made in this letter.

Sincerely,

Gerry Rocchi
President
Barclays Global Investors Canada Limited