



Montreal, June 5, 2002

John Stevenson, Secretary
Ontario Securities Commission
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And

Denise Brosseau, Secretary
Commission des valeurs mobilières du Québec
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P.O. Box 246, 22nd Floor
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**Re: Comments on Concept Proposal 81-402 “Striking a New Balance:
A Framework for Regulating Mutual Funds and Their Managers”**

Dear Sir/Madam,

Please find below our comments regarding the Fund Governance Concept Proposal (the “Proposal”). For ease of reference, the paragraph numbers below refer to the same paragraph numbers in the Proposal.

1. We support the efforts made to improve and implement effective independent fund governance and alignment with mutual fund investor’s interests. We commend CSA for recognizing that “our proposed approach to mutual fund regulation will streamline mutual fund regulation by replacing detailed rules with broader principles. It will also be flexible enough to keep pace with continuing changes to our maturing mutual fund industry”. However, we find that the fund governance regime set out in the Proposal is trying to define the best interests of mutual fund managers by leaving little discretion to adopt different approaches to fund governance.

The CSA should tailor fund governance to the size, complexity and nature of the significant activities and to the risks inherent in the operations of the mutual fund managers and refrain from setting specific requirements.

However, we doubt that the change will represent an improvement over the current model because we do not know which section of the current legislation will be removed. We believe you should eliminate the corresponding regulation in NI81-102 before or at least contemporaneously with implementing the new regulatory regime for mutual funds. Also, we cannot evaluate the full impact of the Proposal because registration requirements have not been elaborated and we do not have detailed information on the product regulation that will be removed. Over the years, the introduction of any new regulation has inevitably increased the regulatory burden. We are not convinced that a governance agency will have a great cost/benefit for unitholders as indicated elsewhere in this letter and more specifically under paragraph 39.

Furthermore, apart from the purpose of a regulatory burden reduction, we do not see any specific improvements that would be generated by such a fund governance agency which the registration of the fund manager would not accomplish. We wish to add that from an economic point of view, the correlation between fund governance and firm profitability is far from obvious¹. In the case before us, firm profitability would be assimilated to the return to unitholders. Since fund governance would add a supplementary cost to unitholders, we think it should at least add value to their investment.

2. We believe that the best alternative would be the registration of a fund manager that will appear itself as an investment advisor/portfolio manager with defined minimum standards but with no obligation to create an independent governance agency, at least, for mutual fund companies that are subsidiaries of a financial group or mutual fund companies that respect a minimum capital requirement. IFIC could promulgate best practice guidelines on that matter.

Of the four alternatives proposed, we favour alternative 3 which will require fund managers to create an independent governance agency but allow them complete freedom to determine its structure, roles and responsibilities. Without increasing the regulatory burden excessively, it increases control over mutual fund managers. If the governance agency has sufficient power to establish its own controls and provides suitable guidance, the regulatory restrictions on products should be removed.

3. Labour sponsored investment funds should be subject to the same regulatory scheme as other mutual funds. Specialized rules have to be applied, if necessary.

¹ S. Bhagat & B. Black, "The uncertain Relationship Between Board Composition and Firm Performance", (1999) 54 Business Lawyer 921. D.R. Dalton, C.M. Daily, A.E. Ellstrand & J.L. Johnson, "Meta-Analytic Reviews of Board Composition, Leadership Structure and Financial Performance" (1998) 19 Strategic Management Journal 269.

4. The renewed regulatory framework should not be extended to all other investment vehicles such as pooled funds because they serve different types of investors. Such funds are set up for administrative reasons by investment advisors/portfolio managers (quite often under a discretionary management account agreement which is already covered by a specific regulation).
5. We believe that the regulatory role should be limited to compliance review as is already the case with other registration categories.
6. We doubt that the Proposal will meet all these goals but it may help to achieve these results.

Portfolio managers and investment advisors have similar duties and functions, are registered with securities authorities and are not monitored by a governance agency. The investments review is performed by way of a peer review (investment committee review). Their fiduciary duty is satisfied through such mechanisms which assume the role of a governance agency. Securities authorities do not require a governance agency.

8. We believe that a flexible approach to fund governance is preferable to a single legal model.
10. If a governance agency structure is required for mutual fund managers, such a structure is similarly needed for owner-operated mutual funds. The defined group of investors often owns the manager indirectly and does not have the tools to ensure that its immediate interest is well served. Such a structure will also maintain a level playing field within the mutual fund industry.
11. No maximum number of mutual funds that can be overseen by a governance agency should be specified because its duties are to develop principles applicable to the overseeing of all mutual funds rather than the micro-managing of the day-to-day management. Types of funds, specific situations and skills of the governance agency members will guide the governance agency in determining its capacity to perform oversight. The Investment Funds Institute of Canada (IFIC) should provide “guidance” to the industry on the scope of oversight for a governance agency.

12. We believe that it may be difficult to recruit qualified members for a governance agency at a reasonable cost. We are of the opinion that there should be no required courses or proficiency requirements for members as that would make it more difficult to recruit qualified members.
13. While we agree in general terms with the proposed definition of independent directors as unrelated directors, we would suggest that interpretative guidance would be useful. The CSA should require a majority (and not a supermajority) of all members to be independent if a governance agency is established. This condition will maximize its influence. We think that it may be useful to have a moderate number of inside directors or officers (involved in the day-to-day management) on the governance agency in order to bring the benefit of their insights.
14. We believe that the renewed Framework should focus on the overall effectiveness of the governance agency and mutual fund managers in protecting the interests of unitholders of mutual funds. The governance agency's responsibilities must not be related to the day-to-day business; that responsibility falls on management. Consequently, mutual fund disclosure does not need to be approved by the governance agency nor does the fund manager's choice of benchmarks. The governance agency has to oversee the mutual fund's management in accordance with the stated objectives.
15. Each governance agency will need to determine the scope and specific nature of its mandate in accordance with the type of business handled by the mutual fund manager. We believe that the industry should develop guidelines of best practices regarding the responsibilities of governance agencies which would require funds to compare and measure their governance practices against such industry best practices.
17. The liability of a governance agency should be limited to \$1 million. Also, the liability of a governance agency member for breaches of the standard of care should be linked to a board of directors of a corporation. Case law relating to this matter is already established which would encourage compliance and enforcement capacity. The members will require the mutual fund manager to give them liability insurance. The cost of this additional insurance will ultimately be borne by the unitholders.
18. A regulatory statement on the standard of care for governance agency members will allow potential members to assess their personal exposure in so acting. We doubt that potential members will be discouraged or deterred from sitting on governance agencies because of their possible liability. The Proposal should clarify the liabilities and defences available to members of a governance agency in order for them to assess their exposure.

20. The only possible way is for the first members to be appointed by the mutual fund manager. Thereafter, governance agency's members will fill any vacancies on the governance agency. Investors must not elect the first members of the governance agency. Election by unitholder meeting or mailing would cost too much, take too long, and ultimately, the cost would be borne by the unitholders.
21. In our view, the issues associated with fund managers appointing governance agency members are theoretical. Members of the governance agency should respect the standard of care statement to act honestly and in good faith in the best interests of the investors. They will do so by keeping in mind the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.
22. Investors who do not like the elected/appointed governance agency members should not be allowed to exit without penalty. The concerns about the appointment of governance members would not lead more than a few unitholders to redeem their units.
23. The CSA should not set limits on giving guidance to the industry on the amount or kind of compensation that may be paid to governance agency members. The CSA should maintain its position regarding compensation. Governance agency members should not be permitted to set their own compensation. The mutual fund manager should be involved in the process of setting the governance agency's compensation or should at least approve it. We doubt that the independence of the governance agency would be compromised. Convening meetings of unitholders is not an option. Governance agency members should have term limits.

The industry will discipline itself. Neither the mutual fund manager nor the governance agency should have the power to call a special meeting to have investors consider any compensation.

24. Removing the fund manager would raise practical issues as it is generally at the core of mutual fund activities. As stated in the Proposal, investors invest in a specific mutual fund when they are comfortable with the fund manager. We agree with IFIC that the power to remove the fund manager is something that investors already have and should be left to the investor.

25. We would rather suggest that the governance agency, having the responsibility of performing its mandate adequately, expel a non-performing member of its own accord. As a last resort, the mutual fund manager should have the option of asking investors to replace governance agency members when they are not carrying out their responsibilities properly, even if this is an expensive solution. But investors usually care less about the Simplified Prospectus or other information regarding the fund than about the performance and where the funds are invested. How could we expect to get their vote on such a matter?
26. In agreement with the information described.
27. The mutual fund manager will have to proceed on a step-by-step basis: create and recruit governance agency members, familiarize them with the specific business. The governance agency will then draft its mandate and its responsibilities. The CSA should allow at least a full financial year for operating the governance agency, thereby giving fund governance members time to adjust their mandate.
28. The CSA should not require training programs for fund governance agency members as that would make it more difficult to recruit members. Each mutual fund manager should have the power to decide whether or not training programs are required.
29. The registration of mutual fund managers is a big issue. The CSA has to streamline as much as possible the registration category for mutual fund managers. Conditions of registration must take into account that monies are held outside the mutual fund manager. The CSA should also take into account that all other entities within the mutual fund group are regulated through an equivalent regulatory framework, e.g., trustee, portfolio manager and mutual fund dealers. In cases where fund managers are subsidiaries of financial institutions, regulatory bodies such as OSFI and stock exchanges already impose compliance rules. The trustee also has a fiduciary duty and is required to act in the best interests of the unitholders.

The registration of mutual fund managers will certainly introduce an additional bureaucratic registration system and increase costs for investors. This mutual fund registration will likely lead to the registration of the senior officers of the manager and its employees. This will again increase the cost of registration. We are of the opinion that relief from regulatory restrictions under NI81-102 and securities legislation must be simultaneous with the implementation of manager registration requirements.

30. We believe that the governance agency should be responsible for overseeing the management of mutual funds, not for assessing the adequacy of senior management and directors of the fund manager. The regulator should take on this role but only to the extent of setting which course each officer should follow.
31. Minimum capital requirements are justified to ensure the permanence of the manager. These requirements should take into account that monies and securities are not in the hands of the mutual fund manager but of trust companies and CDS. Also, with this requirement, it will be more difficult for small mutual fund managers to start up in business.

It seems that the CSA based the capital requirement on Canadian GAAP. This is not really relevant because accounting does not include the element of liquidity and risk valuation. The IDA and MFDA developed a calculation to assess the financial situation of their members (based on financial statements drawn up using Canadian GAAP) and this calculation incorporates a financial risk and liquidity approach. Such an approach should be followed for the capital requirement.

33. Compliance of the mutual fund objectives with its investments could be added to the list of essential internal controls, as well as compliance of the information provided in the prospectus with the mutual fund procedures and investments. An auditor review of internal control is not necessary and we do not ask our auditors to conduct such a review. This would entail unnecessary cost and be a waste of time. A Section 5900 Report on internal controls should be adequate, if a fund manager requests such a review.
34. We agree with the IFIC on that question. We doubt a Section 5900 Report would be necessary in order for managers to fulfil their oversight obligations of third-party providers.
35. No. By establishing additional standards, the CSA would increase the regulatory burden and the cost of complying on an on-going basis.
36. Unfortunately, the Proposal does not include specific proposals in replacing detailed rules with broader principles.

As long as the fund's governance agency establishes its own controls and provides suitable guidance, the following regulatory restrictions should no longer apply: Section 2, 3, 4, 5, 6, 11, 12, 18, 20 of NP 81-102.

37. We believe a governance agency would ensure that the manager complies with its policies regarding related-party transactions and the governance agency could replace the current conflict of interest rules.
38. We believe you do not need to consider defining additional rights for investors. We believe that governance agencies are as qualified as fund investors to approve fundamental changes and that it will reduce costs to mutual funds and funds managers, and indirectly to investors.
39. You should also take into account the additional cost of maintaining and responding to the governance agency's queries, the cost of registration, to cost of responding to the additional criteria as well as the cost of a compliance review by the regulator. The cost of satisfying and maintaining capital requirements does not seem to have been taken into account, nor have the costs related to maintaining a governance agency and registration requirements. The costs of a governance agency need to be proportional to the benefits. The regime imposes costs that will be paid by investors. These elements reinforce our opinion that the cost/ benefit is questionable.

Should you have any questions concerning the above or wish to discuss any of the points raised, please do not hesitate to contact me.

Yours very truly,

“ Louis Arcand ”

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Legal Advisor
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