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June 7, 2002

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario
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and

Denise Brousseau, Secretary
Commission des valeurs mobilieres du Quebec
800 Victoria Square, Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Quebec
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Dear Sirs/Mesdames:

Re: Concept Proposal 81-402 – Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers (the "Concept Proposal")

General Comments/Executive Summary

On March 1, 2002 the Canadian Securities Administrators (the "CSA") published for comment a Concept Proposal, which outlines a renewed vision for mutual fund regulation in Canada. The Concept Proposal includes detailed proposals to reform the current regulatory framework for mutual funds, as well as proposals to improve fund governance. We are submitting comments on behalf of RBC Funds Inc., the manager of the Royal Mutual Funds no-load family and the RBC Advisor Funds family. RBC Funds Inc. is a member of RBC Investments, the wealth management division of RBC Financial Group, and currently has over 37.5 billion in assets under management.

While the Concept Proposal contains 39 specific questions, we have not responded to each individual question. Our comments are focused only on those issues that we feel are of particular concern. We believe that a new fund governance regime should not only enhance unitholder protection, but also support fair and efficient capital markets.

We would like to preface our remarks by commending the CSA on the basic structure that is proposed in the Concept Proposal for regulating mutual funds through independent fund governance agencies. By proposing mandatory independent fund governance, the CSA acknowledges that Canada's mutual fund industry is maturing and that it is necessary to ensure that regulation keeps pace with the complexity and creativity of the industry, as well as with global standards.

The necessity to streamline existing product regulation simultaneously with the establishment of a governance agency

In order for the new fund governance proposals to provide the expected benefits that are outlined in the Concept Proposal, they must be introduced simultaneously with a relaxation of the current regulatory restrictions and prohibitions relating to related party transactions.

The Concept Proposal suggests that the CSA will be re-evaluating some of the detailed rules governing mutual funds that are currently set out in National Instrument 81-102, as well as in other applicable securities regulation. Where the CSA believes that it is warranted, these rules will be eliminated or replaced by broader regulatory principles or guidelines and a requirement that each independent governance agency monitor how these are met by each fund manager.

While we welcome a movement away from detailed and prescriptive regulation towards a more flexible regulatory approach, we note that there is no indication in the Concept Proposal as to when the existing rules will be relaxed and whether this relaxation will occur simultaneously with the creation of the governance agency. In our view, it is critical that streamlined product regulation for mutual funds be introduced *at the same time* that the rules relating to fund governance are introduced and not at a later stage. Any fund group that establishes a governance agency at an early stage should be permitted to take advantage of the relaxed rules upon creation of the governance agency. Any delays in implementing a relaxation of the rules will create undue hardship on funds that create a governance agency early on in the process. Moreover, granting such relief would also act as an incentive for some fund groups to establish a governance agency at an earlier stage.

We are very supportive of the implementation of a mandated fund governance regime, however, in order for the industry and unitholders to derive any concrete benefits from having a governance agency in place, we submit that it must be coupled with removal of the existing product regulation provisions, (including those pertaining to related parties), in National Instrument 81-102 and under applicable securities regulation. In our view, a mandated governance regime that does not provide relief from these provisions simply

adds another layer of bureaucracy and regulation to an already highly regulated industry. We suggest that this is not in the interest of unitholders, who will ultimately bear the costs of further regulation. Assuming that existing mutual fund regulation will be streamlined upon the implementation of an independent governance agency, we are of the view that the new proposed framework will represent a vast improvement over the current model. This point is discussed more fully in Part III of our submission dealing with Product Regulation.

Fund Manager Termination

Neither the governance agency nor unitholders should have the ability to terminate the fund manager under any circumstances. Where there is an unresolved dispute between the fund manager and the governance agency, unitholders should be entitled to full disclosure of any such unresolved dispute and can act accordingly.

The governance agency should provide general oversight

The Royal Mutual Funds have had an independent Board of Governors for more than 8 years and prior to its creation, a number of its existing members served for many years as individual trustees for the then Royfunds. Accordingly, we feel that we are in a unique position to comment on the role and experience of an existing governance agency.

The CSA acknowledge in the Concept Proposal that the role of the governance agency will be to oversee actions of the mutual fund manager in managing its mutual funds to ensure that it acts in the best interests of investors. The CSA specifically state that the governance agency's role will be to *"supervise"* and not to "micro-manage the day-to-day management of the mutual funds."

We agree with this approach and recommend that the governance agency's role should be limited to providing general oversight of the fund manager's affairs and should focus on areas where they can add value to the unitholders they represent, such as ensuring management is properly qualified, has access to sufficient capital and has appropriate processes and controls in place with respect to the funds' investment objectives and strategies.

We support the five-pillar approach for a renewed framework for regulating mutual funds and their managers as set out in the Concept Proposal. It is important to note that mutual fund governance is only one element of this renewed framework. Accordingly, the mandate of the governance agency should not be overly broad and include responsibility for issues that are better addressed under one of the other pillars.

While it may be appropriate to use existing corporate governance models as a starting point for creating a governance regime for mutual funds, there are significant differences between the role of a board of directors of a corporation and what we believe are appropriate responsibilities for a governance agency. Specifically, we would point out that s. 102(1) of the *Canada Business Corporations Act* provides that "… the directors

shall manage the business and affairs of a corporation". In contrast, fund governance must be unitholder focused. This difference must be recognized both in the statutory mandate of the governance agency and in its relationship to the fund manager.

Costs and benefits

In today's competitive environment (narrowing profit margins, alternative products etc.) the regulators should ensure that they are not over burdening the industry by increasing regulation without any corresponding benefits to the industry or to unitholders, who ultimately bear the costs of these proposals.

If our recommendations which follow are adopted (e.g. having a single governance agency for all related funds, capping liability of governance agency members so they can obtain insurance at a reasonable cost, limiting costly unitholder meetings etc.), the costs may, in fact, be lower that those projected by the OSC's chief economist. In the end, costs to unitholders must be balanced with tangible benefits, such as the simplification of existing product regulation.

Need for harmonization

It is of paramount importance that the new fund governance regime be nationally accepted and implemented across all jurisdictions in Canada and not adopted on a piecemeal basis only by certain jurisdictions. We strongly encourage the CSA to ensure that harmonization across all jurisdictions is achieved on this very important initiative.

The following expands on these five major concerns we have with the Concept Proposal, as well as providing comments and suggestions on other issues we have been invited to comment on, in those cases where we believe our experience and judgment may be helpful.

I. Mutual Fund Governance

Establishment of a governance agency

There may be a practical limit to the number of mutual funds that one governance agency can effectively oversee. The primary factor in determining this limit will be the roles and responsibilities of members of the governance agency. Until these roles and responsibilities are clarified, it will be very difficult to assess in any definitive way what this limit will be. In addition, the potential liability to which agency members are exposed may also be a factor that influences this limit.

Subject to the foregoing, we are of the strong view that mutual funds within the same fund family or funds that are managed by the same mutual fund manager would only need one governance agency to oversee all related mutual funds.

The role of the governance agency will be to oversee on behalf of unitholders

In our view, a number of the enumerated responsibilities that are described are inconsistent with the stated role of the governance agency and clearly fall within the purview of the fund manager's responsibilities. In particular, we have the following comments:

Choice of benchmarks - The responsibility of the governance agency to consider and approve the fund manager's choice of benchmarks and monitor fund performance against those benchmarks is inappropriate, and should remain part of the fund manager's role. Instead of approving a benchmark and monitoring the fund's performance against the benchmark, the governance agency could ensure that the manager has a defined process in place for selecting or changing benchmarks and for assessing ongoing performance. In order to ensure that a benchmark is not changed on an arbitrary basis, there should be provisions for the manager to report to the governance agency when it changes a benchmark.

Monitoring a fund's stated investment objectives and strategies – Similarly, we believe it is inappropriate to have the governance agency monitor that the mutual funds are managed according to their stated investment objectives and strategies. In our view, there is nothing more fundamental to the manager's role than ensuring that funds are operated in accordance with their objectives and strategies. Managers should report to the governance agency on their processes and controls to ensure compliance with mandates and any action required where there has been a deviation from the funds' objectives and strategies.

Responsibilities of the audit committee - We submit that it is appropriate for those agency members that act as an audit committee to review financial statements and provide comment on them on behalf of the unitholders *once they have been approved by the manager;* however, we do not agree with the proposal that governance agency members *approve* the financial statements. Again, we believe that this is a fundamental responsibility of the manager and should be performed by the manager's audit committee. We believe that the audit committee should meet periodically with the external auditors to oversee their work and ensure that they are carrying out their duties in an efficient and cost effective manner. The Audit Committee of our Board of Governors acts in this manner and they and we believe that many positive benefits have resulted from it. In addition, assuming there has been an ongoing relationship between the governance agency and the external auditors, we believe that it is entirely appropriate that governance agencies be responsible for reviewing and approving proposals to remove auditors of the funds, provided that this approval is in lieu of any required unitholder approval.

Related party transactions – We support the view that a fundamental role of the governance agency would be to approve the policies of the fund manager with respect to transactions with related parties and independently determine which transactions are in

unitholders' best interests. Indeed, two senior securities commissions have recognized the independence of our Audit Committee in dealing with related party transactions. Our experience has been that approval of related party transactions can be accommodated on either a pre or post transaction basis depending on the circumstances. Depending on the structure of each fund complex, the importance of this role will vary considerably. In complex structures such as ours, this role, and its associated costs, will be significant, as they should be. In other simpler fund complexes this role and its corresponding costs could be minimal.

Review or approval of mutual fund disclosure documents - We do not believe that the governance agency should have to review or approve mutual fund disclosure documents such as the simplified prospectus or annual information form, as this is clearly the responsibility of the fund manager; however, copies of these documents could be provided to agency members to review and comment on the adequacy of unitholder disclosure.

Appointment of the governance agency members

The Concept Proposal states that the initial members of the governance agency will be appointed by the mutual fund manager or elected by unitholders, at the option of the manager. For subsequent appointments, individuals will be chosen by the governance agency members to fill any vacancies.

While we understand the CSA's desire to involve investors in the selection process, we believe that from a practical standpoint it makes more sense for the fund manager to make the initial appointments, as well as to recommend future appointments for approval by the governance agency. The fund manager is better positioned to identify qualified candidates with the necessary skills for the governance agency.

Our experience with an independent, appointed Board of Governors suggests that the risk of "an insurmountable bias in favour of the fund manager" resulting from the fund manager's appointment of governance agency members is unfounded. We submit that this risk is adequately addressed through the imposition on governance agency members of an appropriate "independence" test and a standard of care to act in the best interests of unitholders.

We disagree with the suggestion that unitholders who do not like the elected/appointed governance agency members be allowed to exit a fund without penalty. In particular, we oppose any scheme that would waive deferred sales charges for those unitholders who selected this purchase option. In our view, it would be unfair for anyone other than the unitholder to bear the cost associated with waiving a deferred sales charge. When a unitholder purchases a mutual fund under a deferred sales charge option, the mutual fund company still pays a commission to the selling dealer at the time of sale even though no commission is deducted from the unitholder's principal investment. Over the years, the Canadian mutual fund industry has developed complex financing arrangements to support deferred sales charge regimes. Any regulatory change that would compromise these

financing arrangements would be extremely costly, with no corresponding benefits. In our view, there is also a real risk that investors may abuse this and indicate that they do not like the governance agency members as an excuse to exit the fund without penalty.

Governance agency members will be independent

While we agree that a majority of the governance agency members should be independent, it should be at the manager's option whether all members of the agency are independent. We submit that in order to be effective in its role, the governance agency should also be comprised of members who possess detailed knowledge of the manager's business.

Under the current proposal, a majority of the governance agency members will be independent of the mutual fund manager, including the chair. We assume that any test for determining a member's independence should be reasonable and intended to address real conflicts of interest. For example, a retired executive of the fund manager or its affiliates should not be precluded from acting as chair of the proposed governance agency. We also note that public companies are presently not required to have an independent chairman. We therefore recommend that each fund group be given the freedom to determine which option works best for its organization and that it should not be mandatory for all fund groups to appoint an independent chair.

Members of the governance agency will be subject to a standard of care

The reasonably prudent person standard of care that the governance agency members will be held to is appropriate, however, there are a number of other related issues that need to be considered.

We believe that it is both appropriate and necessary to limit the liability of governance agency members to ensure that managers are able to recruit qualified persons for their governance agencies at a reasonable cost. Exposing members to unlimited liability may deter potential candidates from acting as members of governance agencies and would undoubtedly have a significant impact on the availability and cost of insurance for agency members. Moreover, if governance agency members have unlimited liability they are more likely to independently retain professionals such as lawyers and auditors in order to protect themselves. This would significantly add to the costs that would be charged to the funds and ultimately to unitholders. We submit that it is reasonable that governance agency members' liability be capped at $1 million, as proposed by the Fund Governance Committee of The Investment Funds Institute of Canada. In our view, personal exposure for liability of $1 million would provide adequate incentive for agency members to diligently carry out their duties. We do not believe that such a limit will undermine the stated purpose for governance agencies, or otherwise be contrary to the public interest.

We are also of the view that governance agency members should have a due diligence defence if they perform their duties honestly, in good faith, and in the best interest of unitholders. In his report prepared for the CSA entitled "Making It Mutual: Aligning the

Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada", Stephen Erlichman recommended that fund managers, with input from governance agency members, prepare a compliance plan that would be filed with the CSA. Mr. Erlichman suggests that if the compliance plan is properly reviewed and monitored by the governance agency, it should create a due diligence defence for the governance agency and for the manager of the mutual fund against claims alleging breaches of matters covered by the plan. We submit that this recommendation, which was not adopted in the Concept Proposal merits further consideration.

Finally, we do not believe that the absence of such a limit of liability in the corporate context is justification for failing to stipulate a limit for governance agency members, since their roles and responsibilities will be very different from those of corporate directors. While unlimited liability may seem desirable from a regulatory perspective, we believe that a reasonable limit is both practical and achieves the correct balance between cost and benefit.

Compensation of governance agency members

Under the Concept Proposal, the governance agency members would be able to set their own compensation, which would be paid out of fund assets. If the manager felt the compensation determined by the governance agency was unreasonable its recourse would be to call a unitholder meeting to consider the issue.

We do not believe that governance agency members should set their own compensation or that the regulators should impose a limit on the compensation paid to governance agency members. In our opinion, it is entirely appropriate for the mutual fund manager to set the compensation of governance agency members, since the manager is responsible for the funds' management expense ratios and other costs that will be charged to the funds. Again, our experience with the Royal Mutual Funds' Board of Governors suggests that the independence of the governance agency members will not be compromised if the mutual fund manager sets the compensation of the agency members directly. We believe that given the relatively small and specialized talent pool available for governance agency members, market forces will quickly establish appropriate benchmark compensation.

We do agree, however, that the independence of the governance agency members could be compromised if the fund manager paid the compensation directly, instead of the funds. Since the governance agency is in place to protect investors and represent their interests, it is appropriate that compensation of governance agency members be a fund expense that will be borne by unitholders.

The proposal to give fund managers a veto power over compensation of agency members (by allowing them to call a special meeting of unitholders to consider any compensation that they believe is unreasonable) is not practical and should be abandoned. In our experience, holding unitholder meetings is not only a very expensive proposition, but very few unitholders actually participate in these meetings, either in person or by proxy.

Again, this is not a viable solution given the inherent costs of such meetings that will be borne by unitholders.

Dispute resolution

We strongly object to the ability of the governance agency to terminate the fund manager's appointment with the approval of unitholders where there is an unresolved dispute between the manager and the governance agency. As the CSA correctly points out, dismissing the fund manager would not only subvert the wishes of unitholders who arguably chose to invest in the mutual fund based on its manager, but it could also leave a mutual fund without management. We maintain that if unitholders lose confidence in the manager they can always "vote with their feet" and leave the fund. We are of the view that disclosure to unitholders of any unresolved dispute between the governance agency and the manager would be appropriate and that it should be sufficient to file a press release and prospectus amendment. We submit that the negative publicity of any unresolved dispute would be enough of a deterrent to encourage the governance agency and the manager to try to reach an agreement.

The Concept Proposal suggests that if a manager is dissatisfied with the performance of any of the governance agency members, it will have the option of calling a unitholder meeting to have such persons terminated. While this is a rather draconian measure that likely would never be used, we suggest that there are alternative measures that could also be designed to address non- performance. We agree that the right of the manager to call a special meeting of unitholders should be retained. We also believe that the governance agency should have the power to remove non-performing members, without having to call a special meeting. We believe that the governance agency should report to the manager annually on its own performance, including the performance of its individual members. Where the agency or its members fall below an expected standard (as determined by either the agency or the manager), the governance agency should provide the manager with its proposed actions to improve performance, which may include replacing any non-performing members. Such board performance reviews are becoming more common among public companies and could be easily applied in the mutual fund governance context.

Implementation of governance agency requirements

While we recognize that some fund managers will require time to implement the new fund governance proposals, those managers that have already established independent governance agencies should be granted immediate relief from related party prohibitions and restrictions in National Instrument 81-102 and applicable securities legislation.

II. Manager Registration

We support the proposal that every fund manager will be required to be registered with a principal regulator, or regulators, (through the creation of a new registration category for mutual fund managers), provided that this is done at a reasonable cost. We agree with the

CSA's view that registration of fund managers will give regulators oversight over companies that act as mutual fund managers in order to ensure consistent national minimum standards for mutual fund managers with respect to the required level of capital and adequate compliance measures.

Conditions of registration

Minimum proficiency

The Concept Proposal suggests that each of the senior officers and directors of the fund manager must have at least three years of direct experience working in, or providing service to, the investment fund/securities industry. While we support this requirement for senior officers who are also directors, we believe that such a requirement for non-management directors is not only not warranted, but could in fact lead to sub-optimal governance oversight of the fund manager. A diversity of experience is common among public company boards. The value of such diversity is well recognized as a good corporate governance practice. For fund managers that are public companies, such an experience requirement would be contrary to established governance practices for public companies.

We also recommend that there be appropriate grandfathering of the conditions of registration relating to minimum proficiency requirements.

Minimum capital

We believe that a minimum capital requirement for fund managers is justified. With respect to calculating minimum capital requirements, we support Stephen Erlichman's recommendation that capital should be set at 5 percent of the value of the assets of all mutual funds managed by the manager, subject to a minimum of $100,000 and a maximum of $5,000,000, similar to the provisions established in Australia.

III. Product Regulation

We submit that it is essential that the CSA streamline existing product regulation governing mutual funds concurrently with the introduction of a new fund governance regime. As the CSA has acknowledged, Canadian securities regulators to date have responded to potential conflicts of interest by simply prohibiting certain relationships or transactions by mutual fund managers. This prohibition-based approach is too restrictive and frequently serves to prohibit transactions that may be beneficial to unitholders. We strongly support the notion that related party transactions under the new proposed framework should be regulated through a governance regime rather than restrictive rules and wide-ranging prohibitions.

We submit that the review of product regulation and the re-evaluation of regulatory restrictions should not be postponed until after the manager registration and independent fund governance proposals have been implemented. There are a number of existing rules

and regulations set out in National Instrument 81-102 and applicable securities legislation that are extremely problematic and require urgent attention by the CSA. The following regulatory restrictions on related party transactions should be eliminated as soon as possible:

- prohibition on investing in a security for 60 days if a related dealer underwrote the offering (the "60 day rule")
- dealings between responsible persons
- inter-fund trading
- principal trading
- fund purchases of related party securities
- non-arm's length investment in mortgages

We would be pleased to review with the CSA specific examples of where these restrictions on related party transactions have prohibited transactions that may be beneficial to unitholders.

We also strongly urge the CSA to simplify, or eliminate in their entirety the rules pertaining to the 10% concentration restrictions and restrictions concerning illiquid assets.

We submit that it should be a fundamental responsibility of a governance agency to ensure that a fund manager implements appropriate policies and procedures with respect to related-party transactions. Governance agencies may be in a better position than securities regulators to review and monitor such policies, and address any issues that may arise in a timely manner.

In our view, the approach of using a governance agency to monitor manager compliance with policies on related party transactions can and should replace the current prescriptive rules relating to these types of transactions. As acknowledged by the CSA, the current conflicts of interest rules are significantly flawed and should be completely revised or replaced. We submit that adopting a "code of conduct" approach that allows each fund complex to develop its own specific rules in conjunction with its governance agency (subject to general principles articulated in securities legislation) would result in a more efficient and responsive regime that would protect the interest of unitholders without artificially restraining practices that are innocuous, or even beneficial to unitholders.

IV. Investor Rights

Based on our experience, investors in mutual funds are generally not interested in actively participating in the investment management of their holdings. Consequently, we believe that there are few matters where unitholder approval should be necessary. We support the view that having governance agencies approve many changes that are currently defined as fundamental (rather than unitholders at special meetings) will serve to reduce costs to mutual funds, fund managers and unitholders. We could see the merit in requiring a unitholder meeting for a change in a fund's fundamental investment

objective. However, even in these circumstances, the costs of a unitholder meeting may not be warranted where there is no unitholder cost of exit. It should be sufficient for the governance agency to approve a change in auditors, rather than seeking unitholder approval, as is currently the case. We believe that, given a strong governance agency whose sole mandate is to represent unitholders, and given the cost of unitholder meetings and the generally low participation rates, it should be possible to address virtually all material changes to the business, operations or affairs of a fund through the governance process, and where necessary, through the issuance of a press release (or possibly direct unitholder notice), material change report and prospectus amendment. Further, given the cost of unitholder meetings and low participation rates, we believe that unresolved disputes between the governance agency and the fund manager should be treated in the same manner.

Concluding Remarks

Thank you for providing us with an opportunity to share our comments and concerns. If you have any questions, or require any additional information, please do not hesitate to contact the undersigned at (416) 955-3592 or Lori Lalonde, Senior Counsel, at (416) 955-7826.

Yours sincerely,

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