Westcap Mgt Ltd. (Manager of Golden Opportunities Fund)

Comments on Concept Proposal 81-402

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The following paper provides comments on the CSA's concept proposal 81-402. The opinions are from WestCap Mgt Ltd., the fund manager for Golden Opportunities Fund, a Saskatchewan Labour-Sponsored venture capital fund.

We have reviewed the document "Striking a New Balance: A Framework for Regulating Mutual Funds and Their Managers" and have commented on the questions in the order they are contained in that document.

Our comments are provided in the context of a governance agency that is flexible with respect to form thus reflecting the multitude of mutual fund structures that exist in the Canadian market today. When we speak of a "governance agency" we are speaking in general terms and the entity could be the board of directors in the case of corporately structured mutual fund, trustees in the case of independent trustee administered funds, or an appointed governance committee or board of governors.

Question # 1:

The current regulatory regime is confusing at best and a quagmire at the worst. If there is going to be true reform, the current provincial and territorial securities commissions are going to have to join into one national securities body as a first step. In the absence of a national regulatory body, regulatory and governance reform should be aimed at cost and procedural efficiency, ease of use by all involved, full disclosure, and accountability.

The concept of independent governance has merit. Mutual fund managers should not have full governance authority over the fund structures unless they are the same entity as in the case of owner-operated mutual funds.

The concept of moving away from a prohibition-focused regime to a governance regime also has merit. This would allow mutual fund managers more leeway with respect to the management of their funds within the guidelines established by the governance agency and those that form part of 81-101 and 81-102 for example. The addition of a governance agency without the complete review and governance modifications of 81-102 would not be well accepted.

The concept of a registration category for mutual fund managers also has merit. However, three important points must be addressed. First, the category should not end up eliminating many of the current managers due to onerous financial restrictions. Second, there should be no overlap with other registration categories such as dealer or advisor. This does not preclude multiple registration under the different categories; it simply defines the boundaries. Third, registration in one jurisdiction should suffice for all jurisdictions with the only difference being the amount of fees paid.

Question #2:

The alternative suggested have various deficiencies.

> **Alternative # 1: Non-regulatory approach**.
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> This approach lacks teeth and probably would not make much of a difference in the governance of mutual funds. The assumption is that investors read and understand the prospectus. As such, there will be few if any who actually "demand" explanations of the variation from best practice that may be developed by the IFIC.
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> **Alternative# 2: Reliance on enhanced audit or regulatory functions.**

One only has to look to the Enron debacle to see how ineffective auditors can be. As for regulators, there are serious time/money constraints and cost/benefit issues with enhanced regulation.

Alternative # 3: Require governance agencies but let funds managers determine structure, roles, and responsibilities.

If this path is chosen, then effectively what has been changed other than the form of the current system? We would argue nothing other than costs have just gone up for no real reason. This option would result in agencies that were completely aligned with the fund managers and would not be materially different than the current system.

Alternative # 4: Require fund managers to create an independent governance agency, but do not require fund managers to be registered nor define minimum standards for fund managers.

We believe that an independent governance agency is a good idea if structured properly and that it should be mandated. Current best practice is moving in this direction anyway. The fact that mutual fund managers have a separate category with minimum standards for registration should also be implemented. However, the standards must make allowance for small mutual fund managers in Canada with respect to minimum capital requirements, assets under administration, errors and omissions insurance, and general liability insurance. Without doing so would potentially eliminate some mutual fund mangers immediately.

Question #3 and #4:

Labour sponsored funds have an additional layer of regulation imposed upon them in the form of provincial labour sponsored funds acts. It does not matter if the fund is a labour-sponsored fund, a commodity pool, or a segregated fund. Where there exists the potential for investor abuse brought on by the conflicts involved with the current system, a governance agency should be required.

One of the main determinants should be the average size of the investment. For instance, hedge funds are issued mostly by offering memorandum and the minimum purchases warrant the investor taking the time to read the offering memorandum or to at least seek advice from competent counsel, as required by some exemptions. There is little reason for governance agencies for hedge funds as the investor or the investor's counsel is usually well informed about the product and generally has the financial ability to bring action against the manager. Lastly, these funds typically have a small number of wealthy investors who act as a proxy governance board.

Where the purchase is relatively small and the number of holders is large, as in the case of widely distributed mutual funds, segregated funds, and exchange traded funds, the requirement for stricter governance becomes more important. Many retail investors in mutual funds are apathetic and rely on the advice of their investment salesperson. It is this class of fund investors that would benefit most from a governance agency.

Simply stated, where there is a relatively small purchase, a large number of fund holders, and little if any onus on the fund purchaser to actually read the prospectus or offering document, the requirement for governance is much higher.

As an illustration let us look at actual normal practice in the hedge fund industry and the mutual fund industry. The sale of a hedge fund takes place after an offering memorandum is physically delivered to the potential client. The client or the client's advisor reads the offering memorandum and then a decision is made to purchase or not purchase. Due to the size of the investment or the requirement of the exemption, there is a very high chance that the document was read and actually understood.

With the average mutual fund, the investor speaks to his investment salesperson and decides to purchase given the investment salesperson's recommendation. The order is placed and either a full or a simplified prospectus is mailed to the client. Rarely, regardless of what is supposed to happen and any acknowledgements that may have been made at the time of the sale as to the receipt of a prospectus, does the investor read the prospectus or really understand its implications. This is where a governance agency is required and it should be this test that determines those funds that require a governance agency to look out for investor interests.

Question #5:

As a regulator, there are numerous things that can be done to produce an enhanced regulatory presence.

First, and foremost, the 13 provincial and territorial securities commissions should form a national securities administrator. The balkanised approach is archaic, inefficient, and costly.

Next, regulators require teeth. The current system lacks any real ability to deter abuses. Effectively violators are slapped on the wrist. Regulators must have the weight of criminal and civil law behind them and the ability to impose fines, not negotiate them. Penalties for civil and criminal acts should be severe enough to make people think twice before abusing investors.

If the CSA, in their capacity as regulators, properly execute registration of mutual fund managers, require a mutual fund governance regime that reflects independence with respect to governance issues, streamline and reduce 81-102, and properly introduce an investor rights regime, then enhanced regulatory presence should focus on nationalization and enforcement as mentioned above.

Enhanced regulatory presence should also focus on best practice promulgation for governance agencies, mutual fund manager registration compliance reviews, continued modification and streamlining of 81-102, and a focus on reducing regulatory involvement to an absolute minimum.

Question #6:

Most of the suggestions presented will result in governance that will effectively monitor the actions of mutual fund managers. The question of whether or not the governance agencies have real powers and teeth is another matter and will most likely be determined when the first litigation arises between a governance agency and a fund manager.

Question #7:

No comment.

Question #8:

It is clear from the Steven's paper that a flexible approach would be more appropriate. Given the variety of mutual fund structures within Canada, mandating only one legal form would inject additional cost into the process for those managers not already set up to accept one legal form of governance agency. The substance of the function, not necessarily the form of the function, of the governance agency should be the focus.

Question #9:

There can be no doubt, after reading Mr. Steven's paper and from experience, that there are and can be serious conflicts of interest with respect to the governance of mutual funds when the board of directors or the shareholders of the fund manager act as governance for the mutual fund. The reality of the conflicts in terms of actual harm done to investors cannot be quantified. Clearly, the assumption is these people are aware of the fiduciary and legal responsibilities they have to the mutual fund shareholders which they govern and they ultimately will act in the best interest of the fund.

The imposition of mandated governance assumes that when a conflict arises, it will be settled to the benefit of the fund manager. This most likely is not the case due to the already strict guidelines in current legislation. If anything, we suggest that current practice is to err in favour of the mutual fund shareholders as a manager does not want to risk reputation or business loss due to perceived abuse of conflict of interest rules.

A governance agency has merit for its implicit reduction or elimination of these potential conflicts but it has more value for investor advocacy since most investors in mutual funds are very apathetic when it comes to voicing their concerns regarding the fund to the fund manager.

Question # 10:

We agree with the analysis of owner-operated funds.

Question # 11:

The question of the number of funds that can be reasonably covered by a governance agency is a difficult one. This is really a function of the complexity of the funds covered, the managers covering the funds, and the markets within which they deal or invest. Since the proposal is for flexibility of the governance agency, it will have to expand as required to cover the funds managed by a fund manager. With respect to scope it would be beneficial to have a general scope defined that outlines the broad areas to be covered by the governance agency at a minimum.

Question # 12:

No Comment.

Question # 13:

The definition of an independent member is reasonable. The question of whether or not it should be required that the majority of members are independent of the fund manager should not even be asked. The whole point of this exercise is to reduce or eliminate the conflicts between fund manager and fund. It follows necessarily that the majority of governance agency members must be independent for the goal of conflict elimination to be met.

Question # 14:

The responsibilities listed are appropriate for a governance agency. The agency should also be involved in the review and approval of the fund's disclosure documents. As disclosure documents are key to the investor advocacy role, it would seem logical that the governance agency would have at least a review capacity.

Question # 15:

This will develop as governance agencies develop and will be unique to each fund family and fund manager governed. However, the overriding principle should be that the governance agency has at least a review and comment role in any policy, procedure, or statutory document that can materially affects investor welfare and fund value.

Question # 16:

The effectiveness of anyone on the audit committee is a function of accounting knowledge, the ability to ask the correct questions, and the willingness to seek professional advice when necessary. As an independent director there is separation from the fund manager. The ability to exercise due diligence is not constrained by future employment prospects or by being removed from the board.

Question #17:

There should be no limitation of liability. As corporate directors do not have liability constraints it would be prejudicial to assign a limit to a governance agency member who, in effect, has the same fiduciary responsibilities. People who enter these positions are aware of the liabilities involved and much of the liability is tended to with director's liability insurance.

Question #18:

A regulatory statement on the standard of care should be part of the proposal as it defines the possible liability for someone accepting a position as a governance agency member. We are not convinced that such a statement will be a large deterrent to someone accepting a position on a governance agency. Instead, those that do accept a governance position will be clear on the gravity of their responsibility and as such will be prepared to act in accordance.

Question #19:

No comment.

Question #20:

There are few alternatives to fund manager selection or shareholder selection of the initial governance agency. The only other alternative is for the CSA to advertise in national newspapers and specialized recruiting agencies for governance agency members. The list developed could then be circulated to fund managers for consideration. This would be very time consuming and and costly. We believe that this is where the proposal faces its greatest weakness. The plan calls for a governance agency that is majority independent yet will initially be selected by the fund manager with all related possible conflicts, or will be nominated and elected by shareholders and all the attendant apathy and logistical problems.

Question #21:

The issues concerning fund manager appointment of the first governance agency are mostly theoretical. There can be no doubt that many fund managers will want to appoint a governance agency that, although majority independent, will be aligned with the fund manager. However, a governance agency member subject to the standard of care and its attendant liabilities would consider making decisions subject to regulatory review and possible sanction.

We believe that most mutual fund managers are honest and are looking out for the welfare of the end investor. This should be the assumption that underlies this whole process. And while a governance agency removes the majority of conflicts, in the interest of cost and ease of implementation, the fund manager should chose initial governance agency members.

Question #22:

Investors who do not like the appointed governance agency members and wish to exit the fund should be subject to the terms of their original purchase. The fund manager has not changed and theoretically, this is why they purchased the fund in the first place.

Question #23:

When it comes to the compensation of governance agency members the suggestion that they set their own compensation has merit. It is important though that the fund manager has some form of veto power. We do not feel that this should be put to the investors as it would take much time and expense to get the situation resolved. The regulator may be used in this instance to help establish guidelines, prepare a study on current practice, and act as a mediator in the case of disputes that cannot be easily solved.

Question #24:

The governance agency should not have the power to terminate the manager. It should, however, have the power to call shareholder meetings to suggest changes be made to the manager in the event that disputes cannot be handled properly or resolved. Should the governance agency function as it should, then disputes should be resolved fairly quickly and amicably. The ability to go to the investors would only be a last resort but would be necessary to give weight to the governance agency function.

Question #25:

Investors should not be used to get rid of non-performing agency members. The governance agency's other members will do it if they are doing their jobs. There should be a mechanism in place to make this process function. However, if the governance agency is not doing its job, then the fund manager should have the ability to go to the investors to have the agency removed.

Question #26:

Investors should receive not only the listed documents but also a financial statement of the operations of the agency, the allocation of the agency's costs to each fund they are responsible for, and a report on the effective basis point cost in total performance to the funds covered. This will help investors assess the true cost of the governance agencies.

Question #27:

Mutual fund managers should have at least a minimum of one year to develop a governance agency from the time the proposal is accepted. However, there should also be a deadline so that it actually gets completed, say two years.

Question #28:

The training programs required for governance agency members will vary based on the expertise and experience of the members selected. However, some basic programs will be fund operations, governance law and liability, major functions of governance agencies. This will evolve and will be unique to each fund manager. However, it may be wise to consult with the Canadian Securities Institute to develop a course on mutual fund governance agencies similar to the Partners, Directors, and Officers exam that would be a requirement if named to a governance agency. This would promote at least a modicum of uniformity amongst members.

Question #29:

Conditions of Registration

Senior Management

The fund manager should have at least the following three positions:

- Chief Executive Officer
- Chief Financial Officer
- Senior Compliance Officer

The administrative officer can be filled by any one of the three above.

Criminal Record Checks for Senior Officers

This is already common in other categories.

Minimum Proficiency

Agreed

Filing of fund manager's statements with regulator

Agreed

There are further considerations with respect to registration. First, a grand-fathering provision should be implemented. There are some funds in Canada that are well run that may not meet the requirements as stated. There should be provision for transition to the requirements so that some funds have time to adjust.

Next, the CSA should also consider whether or not the mutual fund manager will have in house investment advisors or external investment advisors. For a fund with internal advisors, it will necessarily follow that the Chief Investment Officer or Chief Executive Officer should at least meet the qualifications required for registration as an Investment Counsel/Portfolio Manager under the Advisor category.

For those mutual fund managers that will be sub-contracting the investment management process, it follows that they should be employing firms that meet the Investment Counsel/Portfolio Manager criteria under the Advisor category.

Question #30:

The governance agency should not be responsible for considering the qualifications or proficiency of the fund manager's management. This is the responsibility of the fund manager's board and the regulatory body.

Question #31:

Minimum Capital will most likely be one of the most contentious issues. If you set it too high then you immediately remove small players from the market. If set too low then there is the risk of new entrants failing.

We suggest the following schedule:

Minimum Capital	Assets under Administration
$ 100,000 minimum to Max .75 %	Up to $ 200 million
Plus if over	
.20 % of the next	$ 200 million to $1 Billion
Plus if over	
.10 % of the next	$ 1 billion to $ 5 billion
Plus if over	
.05 % of the next	$ 5 billion and over

This would enable new entrants to come to market with adequate capital and would allow most current market participants to remain in business. It also recognizes the added liability and reduced management fees that come with larger investments under administration. We reject the net worth test as it is restrictive for those fund managers owned by a parent to whom inter-company dividends flow. As long a minimum capital is met, the net worth test is not required.

Question #32:

The list of insurance risks is complete. We offer that in the case of errors and omissions insurance that you should look to the Investment Counsel Association of Canada (ICAC) for guidance on this issue. They can be found at www.investmentcounsel.org.

Question #33:

The internal controls list is adequate. We do not feel that a regular auditor review is necessary. If you require proper credentials for the CFO and Compliance functions then these will be addressed. Also, the governance agency will be reviewing these as well. To have mandatory audit reviews would be overkill. Many fund managers already consult with their auditors on internal control or have internal audit functions that review these. The practice of surprise inspections may be something that is substituted for mandatory reviews.

Question #34:

No comment.

Question #35:

No comment.

Question #36:

No comment.

Question #37:

No comment.

Question #38:

A fund governance agency would be in a better position than most fund investors to approve auditor changes. If the governance agencies that you envision are truly going to represent the investor, then they should have the ability to make decisions in the best interest of the investor. Most investors never read the information they are sent and as a result the change results from the voting of a few for the welfare of the many. A governance agency would be recognition of this fact in practice.

Minority investors who are facing fundamental changes to their fund and who do not agree should be allowed to exit penalty free. If there is a majority for the change then they are just on the wrong side of the vote and should have penalty free exit granted to them.

Question #39:

We believe that the cost of governance agencies will most likely be underestimated and that the true cost in terms of advisors used, member compensation, and initial disruption to then fund manager will be far in excess of that estimated.

Conclusion:

We welcome the work done by the CSA on 81-402. We believe that it will result in better governance, investor representation, more streamlined decision making, less prohibition based regulatory work and a reduction of conflicts as long as the process is flexible and based on strong principles and guidelines. Any comments or questions with respect to this paper can be directed to the author at:

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