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Dear Sirs/Mesdames:

Re: CSA Concept Proposal 81-402 (the "Proposal")
A Framework for Regulating Mutual Funds and their Managers

This letter is in response to your request for comments on Concept Proposal 81-402, which sets out a new framework for regulating mutual funds and their managers. The following are the comments of Fidelity Investments Canada Limited ("Fidelity Canada").

Who is Fidelity?

Fidelity Canada is one of the largest managers of mutual funds in Canada, with more than $30 billion under management in Canada. We are part of a group of companies known as Fidelity Investments, the head office of which is located in Boston, Massachusetts.

Fidelity Investments specializes in investment management for individuals, and has operations in a number of different countries located around the world. The Fidelity Investments group manages a total of more than $900 billion in more than 275 mutual fund portfolios and other institutional accounts around the world.

Fidelity Investments has been in business for more than 50 years and has grown to become one of the largest mutual fund companies in the world with more than 15 million investors around the world.

General Comments: The Need to Streamline Existing Regulations

The Proposal is an ambitious outline for a renewed framework of regulation for Canadian mutual funds, which includes significant new regulations as well as the prospect of revisions to existing laws. In our submission, it is critical that new regulatory requirements such as an independent governance agency and manager registration not be introduced unless and until the current regulatory regime is streamlined.

In the Proposal, there is a clear acknowledgement of the problems faced by the Canadian mutual fund industry due to existing regulations that are inappropriate, ineffective, or unnecessary. We agree with many of the CSA's own criticisms of the existing regulatory regime as set out throughout the Proposal:

- "Our current regulation… does not reflect the commercial realities of mutual fund management or investing."
- "Although our prohibition-based approach to regulating conflicts of interest may be… a straightforward way to avoid abuses, we recognize its shortcomings."
- "We know that the current approach is too restrictive… because it prohibits transactions that are innocuous or even beneficial to investors…"
- "We… must acknowledge that, as regulators, we often do not have the necessary insight into a fund manager's business to know when to give discretionary relief from our prohibitions."

These statements confirm the wide spread agreement among both industry participants and regulators that there are numerous problems and shortcomings in the current regulatory regime. These problems impose significant costs on the Canadian mutual fund industry. The cost of complying with a complex web of rules, many of which are outdated or nonsensical, that is administered by 13 different regulators, with only loose coordination and harmonization is enormous. Worse, the outcome of this regulatory scheme is not serving the best interests of investors in all cases.

Many innovative products are delayed or fail to come to market at all due to regulatory impediments. Certain investment strategies are prohibited due to regulatory constraints, even though experienced fund managers believe it would be in the best interests of fund investors to pursue those strategies. Many beneficial practices, such as inter-fund trading, remain illegal, with the result that investors continue to incur higher costs than necessary.

The Proposal suggests that the CSA plans to re-evaluate the existing regulation in three areas:

- the possible elimination of related-party transaction prohibitions and restrictions, including related-party underwriting restrictions, inter-fund trading restrictions, principal trading restrictions and restrictions on fund acquisitions of securities of related parties;
- the simplification of investment restrictions and practices, including concentration restrictions, restrictions on illiquid assets, and fund-on-fund structure restrictions; and
- the adoption of general principles or guidelines in lieu of such prohibitions and restrictions.

We submit that these reforms are critical to the success of any new regulatory framework. We strongly urge the CSA not to defer or postpone fixing the problems that all parties acknowledge exist with the current regulatory environment. In our submission, simply layering new rules on top of what we all know is an inadequate foundation is not a step forward.

Specific Comments

As indicated in our introductory comments, we have significant concerns with the existing regulatory regime that applies to mutual funds, and we believe that it is imperative that the current framework be streamlined at the same time that any new requirements are implemented. This concern serves as a caveat to all of the more specific responses that follow. (Note that in these responses the "independent governance agency" is referred to as the "governance agency", "agency", or "IGA", and such terms are used inter-changeably.)

Question

01. 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?

Response

We applaud the CSA's intentions to streamline and improve the existing regulatory regime. Clearly, significant improvements are needed. Indeed, in our submission the scope of the regulatory changes entailed in implementing the Proposal should force consideration of the more basic regulatory challenges facing the CSA today. Given the significance of the new regulations set out in the Proposal, all industry participants should examine the health and functionality of the current regime, with a view to understanding how the new rules will impact the industry and the millions of investors who currently support the Canadian mutual fund industry.

We are increasingly concerned that the basic structure of securities regulation in Canada is becoming outdated, unwieldy, and incapable of properly serving the best interests of investors. Fidelity strongly supports the notion of moving to a single regulator for the entire Canadian securities industry. In our experience, the burden of dealing with 13 separate regulators imposes enormous regulatory costs on industry participants with virtually no incremental benefits as a result of the existence of this diverse set of regulators. Failing a single regulator, enhanced harmonization among the disparate securities regulators would be helpful, and we are very encouraged by the apparent progress being made towards harmonization, a uniform Securities Act, and similar initiatives. We are, however, alarmed by the discrepancy between the CSA's purported objectives and the reality of different rules being developed independently and implemented differently, at the local level. We would strongly encourage the CSA to re-double its efforts to achieve a uniform set of rules, which are administered in the same way, without local aberrations.

In addition to the need for uniform regulation among the various jurisdictions, there is an equally strong need to implement the concept of "functional regulation" whereby similar products are regulated in a similar fashion. Although the CSA seems to be genuinely supportive of this notion, we are alarmed with how slowly these regulatory objectives are being pursued and implemented. Mutual funds are subject to competition from a large variety of substitutes: segregated funds, pooled funds, exchange traded funds, wrap accounts, etc. As the substitute products become a more significant threat to the mutual fund industry, it becomes even more critical that the regulatory burden for similar products become more similar. It is not realistic to expect mutual funds to be able to compete effectively with products that have a significantly different, and much reduced, regulatory burden.

In our submission, the sort of large scale fundamental regulatory reforms outlined above, ought to be paramount in the CSA's agenda for change. We are concerned that adding more regulations on top of the existing, very flawed regulatory base may simply make the task of harmonization (across both jurisdictions and different industries) more challenging.

If, however, the CSA is determined to proceed with implementing the Proposal, prior to achieving the more fundamental changes suggested above, then we believe it is imperative that the CSA simultaneously move to streamline existing regulations, at the same time as the Proposal is implemented. If these changes can be made concurrently, then we believe that the renewed framework outlined in the Proposal could result in a regulatory framework that is not substantially worse than the current model.

<u>Question</u>

02. What is your opinion about the [governance] 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 there other alternatives that we should consider?

<u>Response</u>

Examining alternatives makes sense only if one agrees with the basic premise that there is significant benefit to be gained by implementing fund governance in one form or another. This determination, in turn, cannot be made in isolation. In our submission, it is meaningless to suggest that fund governance or manager registration are inherently good or bad ideas. Rather, we submit that these regulatory concepts can only be evaluated by looking at the real costs and benefits of the initiatives, and a new initiative is only justified where the benefits outweigh the costs.

We are not convinced that fund governance is as necessary or will be as useful as the CSA suggests. First, there is no pressing reason to justify implementation of the Proposal at this particular time. The Canadian mutual fund industry has developed well, is functioning well, and has generally performed well. In the rare cases where problems have arisen, it is not clear to us that fund governance would have been able to prevent all, or any, of those problems. In our experience, the difficult issues that do arise in the management and administration of mutual funds are often subtle, complex, and not readily subject to external scrutiny by relatively novice overseers. Consequently, we remain unconvinced that the new governance agencies will contribute in a meaningful way to protect the interests of investors.

We acknowledge that introducing fund governance may be motivated by the laudable goal of improving the public perception of our industry. This, however, is a relatively modest benefit in our submission, especially in light of the fact that investor confidence in the current regime is fairly high.

Given these modest benefits, we submit that it is important that the costs associated with these initiatives also be modest. As we have argued above, the most effective way to reduce regulatory costs borne by the mutual fund industry would be to implement fundamental regulatory changes such as a single regulator, harmonization, and functional regulation. If it is not possible to implement these basic reforms prior to implementation of the Proposal, then we submit that the CSA must streamline the existing regulations at

the same time as the new Proposal is implemented. Otherwise, industry participants will incur a significant new regulatory burden, which, in our submission, exceeds the incremental benefits associated with it.

Question

03. Do you agree that labour sponsored investment funds (where applicable) and commodity pools should be subject to the same regulatory scheme as other mutual funds (considering the specialized rules that we already have for these specialized mutual funds)? If not, why?

Response

As we argue above, we believe that it is highly desirable to have harmonized rules across different investment products and that the CSA should seek to achieve "functional regulation" as broadly as possible, as quickly as possible.

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?

Response

The reality of the investment industry is that there are large variety of products competing for the attention of investors. Neither mutual funds nor any other product is guaranteed a share of any investor's wallet. If some substitute investment products offer benefits that are similar to mutual funds, but do not incur the same regulatory costs, then it will be increasingly difficult for regulated mutual funds to compete successfully with unregulated products. Consequently, we believe that it is imperative that similar products be regulated in a similar fashion, in all material respects.

Question

05. 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.

Response

As indicated elsewhere in this letter, we believe that the CSA could be a more effective regulator by achieving a harmonization among the various jurisdictions, implementing "functional regulation" whereby similar products are regulated in a similar fashion, regardless of which part of the financial services industry is involved, and by

streamlining existing mutual fund regulations to address long standing problems and deficiencies.

Question

06. As you read this section of the concept proposal, please consider whether you believe our approach will result in mutual funds being monitored by a governance agency that:

    a. effectively oversees the management of the mutual funds
    b. has real powers and real teeth and
    c. adds value for investors

If you agree or disagree that our proposals will meet these goals, please tell us why. What do we need to change in order to achieve them?

Response

We have a number of concerns with respect to the Proposal, details of which are set out elsewhere in this letter.

Question

07.We kept Canadian corporate governance practices in mind as we developed our proposals. Have we omitted an important principle of corporate governance that you think should apply to mutual fund governance?

Response

In considering the application of corporate governance principles to mutual fund governance, we would caution that it is important to focus on the differences between the regimes, as well as the similarities. In a traditional corporate context, the board of directors serves a critical governance role, since there is no other entity to provide a link between shareholders and management, with a view to protecting the best interests of shareholders. In the context of a mutual fund, on the other hand, the trustee and manager already exists and there is a clear fiduciary obligation to act in the best interests of investors. There is no counterpart for a trustee with a fiduciary obligation in the context of a corporation other than the corporation's board of directors. Given this significant difference, we think it is essential that corporate governance principles not be applied too literally in the mutual fund context.

Question

08. Having read the Stevens legal research paper, do you believe a flexible approach to fund governance is preferable to a single legal model, such as a board of trustees for all mutual fund trusts? Why or why not? Do you see any practical difficulties with the

legal options presented in that paper? Are there any other options we should consider? Do you agree with the analysis of Québec civil law?

Response

We agree that a flexible approach to fund governance is preferable.

Question

09. David Stevens writes about structural and situational conflicts in a mutual fund context. Do you agree with David Stevens' description of the conflicts? We agree with him that serious conflicts arise when the boards of directors of a fund manager or its shareholder(s) propose to act as the governance agency for a mutual fund and we propose to prohibit this. Do you agree with this conclusion? Please explain your answer.

Response

David Stevens has correctly outlined the inherent conflicts between the interests of a fund manager and a mutual fund. While we believe that a commitment to discharging a manager's fiduciary responsibilities can provide the guidance to successfully manage such conflicts, we acknowledge that where a manager's board actively governs the manager with a view to a profit, the same entity cannot provide truly independent fund governance.

Question

10. Do you agree with our proposals and our analysis of owner-operated mutual funds? If not, please explain.

Response

We do not agree with your analysis regarding owner-operated mutual funds. In our submission, there is rarely, if ever, a complete alignment of interests between the investors in a fund (who may or may not be direct participants in the ownership entity), the fund managers (who are employees subject to the same incentives and disciplines as any other employees), and the owner/operator entity. In most cases, we suspect that the incentives and rewards provided to the management team, *qua* employees, are different than the incentives and rewards enjoyed by the ownership group. Given these differences, we believe the same types of conflicts of interest can arise in an owner-operated mutual fund, as in any other mutual fund scheme.

Question

11. 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?

Response

Fidelity has practical experience with having more than 200 U.S. mutual funds overseen by a single "governance agency". Our experience is that this sort of structure enhances the expertise of the trustees, while minimizing the cost per fund. We do not believe it is necessary or desirable to specify the maximum number of funds that may be overseen by a single governance agency.

Question

12. 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?

Response

We believe that managers may find it very difficult to recruit qualified members for governance agencies at a reasonable cost. The extent of this difficulty will be largely determined by the role and responsibilities of governance agencies, and the liability to which agency members are exposed. In addition, there is also a limited "talent pool" from which to choose independent agency members.

Although Fidelity Canada has not had any experience recruiting members of a governance agency in Canada, we have extensive experience in such recruitment in other jurisdictions. The process of recruiting and training fund directors is very expensive, in terms of both time and financial costs. In our submission, mutual fund companies in Canada should expect the task of finding and retaining qualified candidates to be expensive and time consuming, especially given the novelty of the position.

Question

13. 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?

Response

We do not object to the definition of independence proposed in the paper. We do not think it appropriate that all members of a governance agency be independent. In our view, the participation of persons familiar with the day-to-day management and operation

of the funds being overseen by an agency is crucial to ensuring that the agency carries out its roles and responsibilities in an efficient and effective manner.

Question

14. 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?

Response

In principle, we support the general description of responsibilities set out in the Proposal, although we have reservations about requiring the governance agency to act as the "audit committee" for the mutual funds.

The financial statements for mutual funds are transparent and the numeric/quantitative disclosure that must be set out is already prescribed. As a consequence, we submit that review of financial statements by independent governance agency members should be limited to ensuring that the information presented and the manner of its presentation represents meaningful disclosure to unitholders. Governance agency members should not be required to assume a traditional audit function or be required to approve financial statements. In our submission, this additional responsibility may also increase the difficulty of recruiting qualified members for an IGA.

Governance agency members could be entitled (but not required) to communicate directly with internal and external auditors of the funds to the extent such communication is necessary to fulfill their role and responsibilities. In addition, we believe it is reasonable 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.

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?

Response

We think that governance agencies should consider and review policies and procedures for fund mergers, inter-fund trading, and other similar matters that have not been easy to deal with under the current regulatory scheme.

Question

16. Do you believe the independent members of the governance agency will be effective in their audit committee role?

Response

We do not agree that it is necessary for agency members to fulfill a full traditional audit committee role. Independent members of the governance agency should have their oversight duties limited to the review of information presented and the format of its presentation for the purposes of assessing its meaningfulness to unitholders.

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?

Response

One million dollars is the general statutory limit of liability for any breach of securities act provisions. The legislature has seen fit to adopt this figure as sufficient to induce compliance with securities legislation and we feel that this limit is appropriate for the personal, individual liability of governance agency members.

We believe that a limit on the liability of governance agency members is desirable to ensure that managers are able to recruit qualified persons at a reasonable cost. Exposing members to unlimited liability will deter qualified persons from acting as members of governance agencies and will have a significant impact on the cost of the insurance required by members (which will be passed on to investors).

In addition, we are uncomfortable with the suggestion that unlimited liability is necessary to ensure that agency members are adequately diligent in carrying out their duties. In our view, personal exposure for liability of up to, for example, $1 million will provide ample incentive for agency members to diligently carry out their duties. We do not feel, therefore, that such a limit will undermine the stated purpose for governance agencies or otherwise be contrary to the public interest.

Question

18. Will a regulatory statement on the standard of care for governance agency members allow potential members to assess their personal exposure in so acting? Will potential qualified members be deterred from sitting on governance agencies?

Response

We expect that personal liability for members of the fund governance agency will be a significant issue for individuals considering accepting appointments to such an agency. Consequently, anything that the regulators can do to clarify and constrain the personal exposure of agency members will be welcome. In the absence of clarity and certainty of the potential personal exposure, we believe that qualified candidates may be significantly deterred from sitting on governance agencies. To that end, we submit that a regulatory statement on the standard of care may be of significant assistance to prospective agency members, provided it accommodates a form of "business judgment rule" and does not create numerous technical requirements.

Question

19. If you have experience with a governance agency for your mutual funds, how have you analysed their liability under common law or otherwise? Have you obtained insurance coverage for the members of your governance agency?

Response

We have no relevant experience in Canada.

Question

20. Are there alternatives to the appointment-election conundrum we outline? Is there another practical way for members to be appointed to fund governance agencies?

Response

We believe both the initial appointments and subsequent ones should be made by the fund manager. The fund manager is well-positioned to identify qualified prospects and build an IGA with the necessary skills to carry out its mandate.

We do not believe it is practical to expect unitholders to nominate IGA members given that they are in an even worse position to fully know what the role of the IGA is to be and what the necessary skills are to carry out the role.

We do not feel it is appropriate for the IGA to fill vacancies on the IGA or to make further appointments independently of the fund manager. We believe that such appointments should be made by the fund manager and ratified by the IGA. This process will ensure that the Fund Manager selects well qualified members, but provides some independent confirmation through the ratification process.

Question

21. What do you think about the issues associated with fund managers appointing governance agency members? Are these real or theoretical? If you act on a governance agency and were appointed by the fund manager, please share your experience with us.

Response

Fund managers have a statutory duty to act as fiduciaries and in appointing independent governance agency members would be obligated to meet this standard of care. We believe that the risk of an insurmountable bias in favour of the fund manager owing to the fund managers' appointment of IGA members is theoretical. We are of the opinion that this risk is appropriately addressed through the standard of care imposed upon the IGA to act in the best interests of unitholders. Although we acknowledge that having the fund manager appoint agency members may raise some theoretical concerns, we do not expect that this approach would give rise to any practical problems.

Question

22. Should investors who do not like the elected/appointed governance agency members be allowed to exit without penalty? Do we need to give any guidelines for qualifications of prospective members of a governance agency?

Response

Mutual funds investors can always redeem at the full current net asset value per unit. But, in our submission, there is no basis to excuse those investors who have chosen to buy their units on a deferred sales charge basis from the financial obligations they have voluntarily agreed to. We strongly disagree with the notion that investors should be allowed to exit without paying any applicable deferred sales charge simply because they claim that they do not like the elected/appointed governance agency members. Given that all investors bought into the fund when there was no IGA at all, we submit that it would be absurd to give those investors a free redemption right on the basis that they do not like the new IGA.

Question

23. Some people are concerned about the lack of checks and balances on the governance agency setting its own compensation. We do not currently propose to place any limits on the amount or kind of compensation that may be paid to governance agency members. Should we set limits to give guidance to the industry? Should the mutual fund manager be involved in the process of setting the governance agency's compensation or not? Would the independence of governance agency members be compromised if the mutual fund manager set and paid their compensation directly? What do you think about our proposal that the fund manager be given veto power via

the ability to call a special meeting to have investors consider any compensation that the fund manager believes is unreasonable?

Response

We do not believe that the regulators need to prescribe dollar limits on IGA compensation, as we submit that a competitive Canadian mutual fund market will provide more efficient and effective guidance.

We are concerned with the proposal to permit governance agency members to set their own compensation. Rather, we believe there ought to be a form of check and balance on this decision. To that end, we believe that responsibility for setting agency members' compensation should be left to the sole discretion of the fund manager. In our submission, the manager is well placed to assess the responsibilities and liabilities faced by governance agency members and to assess compensation in the context of the overall market. We do not believe that the independence of governance agency members will be compromised by having the manager set their compensation in this way.

Question

24. Will the governance agency have sufficient powers in the event of a dispute with a fund manager? Will it be able to discharge its functions properly? If not, can you suggest alternatives for effective dispute resolution? If you do not agree with our discussion on the powers to terminate the fund manager, please explain why you disagree.

Response

The management of mutual funds is a fiduciary responsibility. Success in this industry is directly correlated with the fund manager's ability to command the trust and respect of investors. That measure of trust is, in turn, directly correlated with the manager's brand and reputation in the marketplace. Consequently, we submit that the most effective tools to motivate and discipline fund managers are a threat to their reputations and the ability of investors to redeem. We submit that the most powerful weapon to assist a governance agency in resolving a dispute would be the threat to make the matter public, as this could substantially harm a fund manager's reputation, if the investing public viewed them to be acting unfairly or in an untrustworthy fashion.

We do not believe that there is much point in giving the agency the power to call meetings of investors. Mutual fund investors have shown, time and time again, that they have little to no interest in attending unitholder meetings. Consequently, any actions taken at such a meeting cannot be interpreted as representing the will of the majority of investors and so such a process does not, in our submission, serve as an effective dispute resolution mechanism.

In particular, we would have significant concerns over the ability of the governance agency to call a meeting with a view to terminating the relationship with the fund manager. In our submission, such a meeting is unlikely to serve a useful purpose, since most dissatisfied investors will have long since redeemed out of the fund and only satisfied investors are likely to remain invested long enough to actually participate in the vote. Consequently, we expect that such votes will rarely, if ever, terminate a management relationship, and so will not serve their purported objective, even though substantial expense will have been incurred. We note that this conclusion is supported by actual experience in the U.S., where no fund manager has ever been successfully removed by a shareholder vote.

Question

25. What do you think about our suggested approach for dealing with non-performing fund governance agencies or individual members? Do investors or fund managers need any additional powers or information?

Response

As indicated above, we do not believe unitholder meetings are an effective or efficient method of resolving most questions. In particular, we do not believe that such meetings would be an effective forum to assess the performance of a fund governance agency or its individual members. Rather, we believe that the fund manager will be best placed to make these evaluations. Moreover, as indicated above, we believe that the fund manager should have the responsibility to appoint members of the governance agency.

In our submission, fund managers are likely to exercise this power with restraint and always with a view to the best interest of investors, since the risk of significant adverse publicity would be dramatic in the event that a fund manager were alleged to have acted unfairly, arbitrarily, or contrary to the best interests of investors. We submit that this fear of adverse publicity will serve as a significant restraint on fund managers on misusing this power.

Question

26. What information do you think investors should receive about the governance agency in addition to, or in substitution for, the information we outline?

Response

We feel that the recommendation to include disclosure of the governance agency members in the simplified prospectus is inappropriate. We do not believe that IGA information is key information that investors must consider before making an investment decision. Rather, we feel that this should be disclosed in the AIF, together with the disclosure on the officers and directors of the fund manager and other parties.

Prospectus documents are already unwieldy – they are very thick, expensive to print and costly for dealers to mail. Adding IGA information is unlikely to make it more likely that investors will read the point of sale document before making an investment decision.

Regulation should focus on reducing the contents of the point of sale document and referring investors to web sites and other forums where investors have access to a very thorough document that contains all of this information, including information on governance roles, objectives, conflicts, etc. This would serve as a permanent record that can be regularly updated. Rather than continually amending simplified prospectuses, summary disclosure on web sites could inform and update investors of these changes. We respectfully encourage the CSA to re-examine the disclosure requirements and seek more efficient delivery media.

Similarly, with respect to annual reports, we do not believe that investors generally review or benefit from the bulk of the disclosure included therein. Consequently, we would encourage the CSA to consider the option of referring investors to a web site or other appropriate source of information for details on the governance agency.

Question

27. How much time do you think we should allow mutual fund managers to develop their governance agencies?

Response

Without knowing the specific details of any fund governance proposal, it is difficult to predict how long firms will need to implement a governance agency. We would, however, encourage the CSA to contemplate a lengthy transition period (e.g. at least 18 months or more) in order to ensure that all firms have sufficient opportunity to recruit appropriate members, train them adequately, and develop a robust framework for the governance agency.

Question

28. What kind of training programs do you think will be necessary for fund governance agency members?

Response

The training required for governance agency members will depend, in large part, on the specific responsibilities and liabilities to which they will be subject. We believe that the necessary training can be developed by the industry and we do not believe there is a need for regulatory intervention in this area.

Question

29. What are your views on registration of mutual fund managers? People have told us that they are concerned our proposals will introduce an additional bureaucratic registration system. If you share these concerns, please feel free to share them with us. However, please understand that our aim is to ensure that the mechanics of registration are as streamlined as possible. We are most interested in your views on our proposals about the conditions of registration of fund managers.

Response

Although we are concerned about further increasing the regulatory burden on the fund industry, we would be prepared to support registration of fund managers provided that there is no duplication or unnecessary increase in the costs of regulation.

While we are sympathetic to the CSA's desire to ensure that all mutual fund managers are registered to provide the CSA with jurisdiction over such entities, we do not believe that many of the traditional registration requirements apply to mutual fund managers. For instance, we do not believe that individuals should be required to pass any of the existing "partners, directors, and officers" exams since none of them relate specifically to the matters with which mutual fund managers must concern themselves. Similarly, we are dubious about the need for capital requirements, for the reasons outlined below.

Question

30. 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?

Response

As indicated above, we believe it is difficult, and possibly inappropriate, to attempt to mandate specific proficiency or experience requirements for the senior executives of a mutual fund manager. Unlike advisors or dealers, mutual fund managers typically do not deal directly with members of the investing public. Thus, there is little or no need to focus on investor protection (since that objective is served through the regulation of

advisors and dealers who have more direct contact with investors). As a result, we have reservations about whether it is necessary for either the governance agency or the regulators to attempt to establish or monitor such standards.

Question

31. Do you believe a minimum capital requirement is justified? What do you think about the three options that have been recommended to us? Can you suggest an alternative option?

Response

We are not convinced that a minimum capital requirement for mutual fund managers is either necessary or desireable and we believe that such a requirement may create an unnecessary barrier to entry to the industry.

Unlike dealers or financial institutions in other industries, mutual fund managers do not have principal responsibility for liabilities payable to investors. All mutual fund assets are held in trust with an approved custodian. Consequently, the financial condition of a mutual fund manager is, to a large extent, independent of the size of the mutual fund assets it manages and the performance of such funds. In this sense, we submit that a mutual fund manager is more similar to a law firm or other professional service provider than it is to a financial institution in which the public invests or makes deposits. For these reasons, we submit that minimal capital requirements may well be inappropriate for mutual fund managers.

Indeed, we see no reason to link assets under administration with the capital required for the business. In fact, given that the asset management business is not a capital intensive business, it seems inappropriate to do so. The Proposal also raises the very real problem for a growing manager that they may be required to stop sales of popular mutual funds if they are not able to obtain additional capital needed not by the business, but by a regulation.

In our submission, most of the risks that a minimum capital requirement are intended to mitigate can be better addressed through other means, such as insurance requirements. In the event that the CSA concludes that capital requirements are necessary, notwithstanding the above submissions, then we would urge the CSA to adopt modest requirements that do not vary based on assets under administration with a mutual fund manager.

Question

32. Is our list of insurable risks complete? We will need to determine the appropriate minimum levels of coverage for the insurable risks. Can you offer us any guidance on this matter?

Response

The proposed list would appear to include all appropriate risks. We recommend, however, that this list be reviewed with qualified insurance specialists to ensure that: (1) it includes all relevant risks; (2) coverage is available for these risks; and (3) these risks are insurable at reasonable costs.

In addition, we would submit that it is appropriate only that fund managers be required to consider the amount of insurance necessary with respect to the types of risks shown, and that there be few, if any, requirements to actually acquire insurance to cover all risks, since it is possible that it may be more sensible to "self insure" some risks, depending on their nature and the terms and costs of available coverage. These are decisions that, in our view, are best left with the fund manager and which should not be second guessed by a regulator.

Question

33. Is our list of essential internal controls complete? Do you think our proposal for an auditor review of internal controls is necessary? Why or why not? Do fund managers today routinely ask their auditors to conduct this review?

Response

We do not believe that auditors should be given the burden of reviewing internal controls beyond their current practices for the purposes of the preparation of their review of the financial statements of the manager. The CICA currently has in place standards for reviews of internal controls (a Section 5900 review) which results in a significant financial cost without, in our view, any significant benefit in these circumstances. Furthermore, any proposed additional reviews by auditors should be discussed in detail with the CICA and major audit firms to determine (a) are they feasible, and (b) what is the estimated approximate costs.

We do not believe that fund managers, or most other businesses, routinely request their auditors to conduct detailed reviews of their internal controls.

Question

34. It has been suggested to us that the CICA provisions respecting Section 5900 Reports may be of assistance in discharging regulatory obligations of the fund manager to satisfy itself, and demonstrate on an ongoing basis, that a third party service provider is competent to fulfil the functions in question. Independent external auditors would perform this audit and the report would be filed with the manager and regulators. Do you believe a Section 5900 Report would be useful in this context? Why or why not?

Response

We do not believe that it is appropriate to require third party providers to obtain a Section 5900 report from an accounting firm as a condition of providing services to a manager or a fund.

Question

35. Can you think of any other minimum standard that should apply to fund managers as a condition of registration?

Response

We are not aware of any other minimum standards that should apply to fund managers.

Question

36. Please provide us with your views on how we can best achieve our objectives of re-evaluating product regulation. What changes are most important to you and why are they important? What aspects of product regulation do you think cannot be changed?

Response

We respectfully submit that it is essential that the CSA revise and improve the existing regulatory framework governing mutual funds, prior to or in any event no later than, the time that it implements the new fund governance and manager registration rules. All parties, including both the CSA and the industry, agree that there are a number of areas in which the current regulations are inadequate, unnecessary, or problematic. These regulatory shortcomings increase the regulatory burden borne by the Canadian mutual fund industry, without adding any meaningful regulatory benefit. We submit that the CSA can best achieve its objectives by fixing the existing regulatory problems before adding yet more regulations to an already heavily burdened industry.

In considering changes to the existing rules, we submit that the CSA ought to rank the issues in terms of priority. First, there are a number of existing regulations that do not function well and require urgent attention. In this group, we would include rules related to related party underwriting (the "60 day rule"), inter-fund trading, securities lending, fund-on-fund structures, and principal trading rules. Second, there are several existing rules that may become redundant or unnecessary once a fund governance regime is implemented and which should therefore be eliminated or significantly revised. This category includes many of the investment restrictions (e.g. concentration, illiquidity) as well as many of the related party rules.

With respect to the first category of regulation, we believe that, whether or not a new fund governance model is introduced, the product regulation falling within this category should be fixed as soon as possible. With respect to the second category, we believe that

changes should be made if, and at the same time as, a new fund governance model is introduced

Question

37. Is it realistic to expect that the governance agency will ensure the manager complies with its policies on such matters as related-party transactions? Can this approach replace the current conflicts of interest rules?

Response

We submit that it is realistic to expect that a governance agency will ensure that a fund manager complies with its policies on such matters as related-party transactions. In fact, we submit that a governance agency is in a better position than securities regulators to monitor and enforce such policies, because it will be closer to the mutual funds it governs, it will have a better idea how they operate, and it can act quickly to remedy any issues that may arise.

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 conflicts of interest rules. The current conflict of interest rules are significantly flawed and should be significantly revised, if not entirely replaced. The approach of allowing each fund complex, in conjunction with its governing agency, to develop its own tailor made rules – perhaps subject to general principles articulated in legislation – should allow for a more finely developed regime that would protect the interests of investors without artificially restraining practices that are innocuous or even beneficial to investors.

Question

38. What are your views on the specific areas that we are re-considering? Are there other changes we should consider in the area of investor rights in light of our proposed renewed framework? Do we need to consider defining additional rights for investors?

Response

It is clear that investors in mutual funds are not generally interested or willing to participate actively in the management of their investment holdings. Consequently, we believe that there should be few, if any, matters that require investor approval prior to implementation. In most, if not all, cases, approval by the governing agency ought to be sufficient. For instance, an "easy case" is that mutual funds should be able to change auditors without seeking investor approval.

The one area in which we would contemplate retaining investor approval would be where there was a change to a new, unaffiliated management company. In our submission, the fundamental choice being made by investors when they select a particular mutual fund is

the choice of mutual fund manager. Consequently, this is one issue on which we believe it is reasonable to continue to require investor approval.

In considering the issue of investor rights, the CSA has given notice that it is considering the issue of "minority rights" which could allow fund investors to redeem from a mutual fund without paying any applicable deferred sales charge. We are strongly opposed to any scheme that would waive deferred sales charges.

First, we would submit that "minority rights" are not required since the very nature of a mutual fund is to permit an investor to redeem at current value, at any time. Unlike a corporate environment, in which there may be legitimate disputes over valuation, mutual funds are always priced at fair market value. Thus, there is no need to provide special rights to allow "dissenting" investors to obtain "fair value".

Second, there is no logical connection between a change in a mutual fund and an investor's obligation to fulfill his or her contractual commitment to pay a deferred sales charge, if that is the option he or she selected. Although different funds offer different purchase schemes, most offer investors a choice as to whether they wish to pay a commission at the time they purchase (a "front end load") or when they redeem (a "back end load"). This choice is analogous to a decision about how to finance a new car purchase (e.g. purchase vs. lease). A mechanical problem with your new car doesn't allow you to escape your lease obligation, because the financing arrangement is not considered to be integrally related to the basic soundness of the car. Similarly, an investor's choice of commission structure is not fundamentally connected to the underlying mutual fund that the investor purchased. In our submission, it would be a dangerous and flawed initiative to connect the basic structure of a mutual fund to the choice of commission financing selected, as there is no sound analytical basis for such a connection.

Third, it would be unfair for anyone other than the investor to bear the cost associated with waiving a deferred sales charge. When an investor purchases a mutual fund under a deferred sales charge option, the mutual fund company nonetheless pays a commission to the selling dealer, at the time of the sale, even though no commission is deducted from the investor's principal investment. Typically, this commission payment is financed through a third party, which may include a bank or even public investors. As part of the financing, the mutual fund company typically incurs an obligation to pay an annual fee (the "distribution fee") to the financing party as well as an obligation to pay any back end loads received on redemption. This obligation is a fundamental part of the economic viability of such financing schemes.

If the CSA were to introduce a rule excusing redeeming investors from paying their deferred sales charges, in certain situations, it would be necessary to determine who would bear that cost which the investor is no longer obliged to pay. In our submission, there is no party on whom it would be fair and appropriate to impose this cost:

- the mutual fund itself should not bear the loss, since the innocent investors remaining in the fund have not done anything to justify imposing an additional cost on them;
- the mutual fund manager should not bear the loss, since it has done nothing wrong, and – in any case -- requiring managers to absorb potentially significant deferred sales charge liabilities would effectively foreclose any such transaction since the economics become unviable; and
- there is no basis to impose the loss on the innocent third party financier which has done nothing to disentitle itself to its contractual entitlement.

Deferred sales charge financing is a significant part of the Canadian mutual fund industry. Over the years, the industry has developed complex financing schemes to support deferred sales charge regimes. Any regulatory change that would unravel these financing arrangements would be extraordinarily costly, with no corresponding benefits. In our submission, there is a significant risk that a minority rights regime would be abused by some investors who could use it as an excuse, which they otherwise would not have, to exit a fund without penalty. In our submission, the existence of an independent governance agency would provide sufficient protection for investors, and therefore should eliminate the need to provide minority rights.

Question

39. Upon reading the staff research paper, what are your views on the costs of our proposals versus the benefits? Should we take into account other costs? Other benefits?

Response

As we have indicated throughout this letter, we have a number of concerns with the Proposal, and we remain unconvinced of the benefits to be derived from independent governance and manager registration. Moreover, we are concerned that staff may have dramatically underestimated the full costs associated with the Proposal, and the impact that such costs may have on some firms.

Conclusion

Although Fidelity Canada has a number of concerns with respect to the Proposal, we would be prepared to support the implementation of the Proposal, provided that it is done in conjunction with a simultaneous streamlining of existing regulations to remedy problems that exist under the current law. The CSA, by issuing the Proposal, has indicated a willingness to move boldly to implement its vision for a renewed regulatory framework. If the CSA is to proceed, we urge them to implement this new framework as a coherent whole incorporating both additions to the existing regime as well as deletions and repairs to current law, rather than adopting a piecemeal approach.

Many of the reforms under discussion have been on the CSA's agenda for a decade or more. To date, the CSA has not demonstrated the same zeal for removing bad old laws as they have for introducing new ones. We believe it is important that the CSA seizes the opportunity, at this time, to implement a comprehensive set of truly valuable reforms, all at once. In our submission, this kind of comprehensive integrated reform is the best way to support and enhance the health of the Canadian mutual fund industry and protect the best interests of Canadian investors.

We appreciate the opportunity to comment on the Proposal, and look forward to a continuing dialogue regarding the best way to improve regulation of the Canadian mutual fund industry.

Yours very truly,

[signed] "Martin T. Guest"

Martin T. Guest
Vice President & Corporate Counsel