June 7, 2002

c/o Finance Area, 3rd Floor
Schulich School of Business
York University
4700 Keele Street
Toronto, Ontario M3J 1P3
Tel: 416-952-9996
lawrence_schwartz@ca.telus.com

Canadian Securities Administrators
c/o Mr. John Stevenson, Secretary
Ontario Securities Commission
19th Floor
20 Queen Street West
Toronto, Ontario M5H 3S8
jstevenson@osc.gov.on.ca

c/o Mme. Denise Brousseau, Secretary
Commission des valeurs mobilieres du Quebec
800 Victoria Square, Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Quebec H4Z 1G3
consultation-en-cours@cvmq.com

Dear Sir and Madam:

The Canadian Securities Administrators ("CSA") has invited public comment regarding proposals for mutual fund regulation discussed in the Concept Proposal 81-402, March 1, 2002 (the "Concept Proposal").

I appreciate the opportunity that the CSA has afforded to make the following comments and recommendations, principally in connection with the proposed "governance agency" as it would apply to conventional open-ended mutual funds.

1. Overview

In my view, the governance agency as presented in Concept Proposal is a sensible response to some of the problems that securities regulators have identified. In particular, it appears that regulators are prepared to consider reducing restrictive and costly regulatory requirements, but only if they are satisfied that conflicts of interest, whether actual or potential, are satisfactorily addressed. On this basis, the Concept Proposal can be supported, subject to certain qualifications.

While the Concept Proposal makes it clear that cost-savings to the industry are not the only reason for the initiative, it is also clear from the discussion of quantitative benefits in the Background Research Report (at 30) that such savings are a significant part of the rationale. Cost savings to the industry, along with the suggested lower fees to investors, and the prevention of investor losses due to abusive managerial conduct provide a strong rationale for the recommendations in the Concept Proposal to the extent that they significantly offset the costs associated with implementation.

However, each of these rationales presents significant concerns, in part, because they have not yet demonstrated adequately. The Concept Proposal does not indicate what regulatory measures will be modified or eliminated, so that it is not possible to judge the extent to which the cost-savings to the industry will offset the added costs of governance agencies. Similarly, the possibility of lower investors' fees and hence better returns is suggested but not established; apparently this matter will be the subject of further research.

Finally, no evidence of abusive conduct by fund managers is presented or acknowledged, so that it is not possible to estimate the types or magnitudes of investor losses that the governance agency could reasonably be expected to prevent. There are to date no studies that support the suggestion of managerial abuse. Fund litigation has been almost completely absent since the current governance rules were adopted over thirty years ago. Moreover, such inquiries as have been made suggest the absence of abusive managerial conduct. For example, after their detailed review of "front running", securities regulators concluded that that form of abuse was not of concern in the fund industry.

The Ontario Securities Commission has apparently undertaken a long-term review of mutual fund managers that would shed light on matters relating to abusive managerial conduct. It would be premature to institute significant reforms premised on such abuse; at the very least, new governance measures should be informed by the early results of that inquiry.

All of this being said, the Concept Proposal remains valid if the main concern of regulators is to deal with possible conflicts of interest that may result in the future, when certain regulatory measures are modified or eliminated in response to the industry's demand for lower compliance costs. The "cost-benefit" approach suggested in the Background Research Paper provides the appropriate framework in which to assess these issues.

Developments in other jurisdictions, alone, are not a sufficient rationale for implementing the Concept Proposal. Other jurisdictions may be responding to investor abuse that has not been experienced in Canada. Moreover, since Canadian securities regulation is very advanced in comparison with most other countries, it is not clear what is necessarily gained by following them. Finally, if particular Canadian fund management companies want to establish the type of governance agencies that other jurisdictions have adopted, surely they are free to do so without Canadian regulatory pressure.

2. Costs and Benefits, Generally

The Concept Proposal concludes the costs associated with the governance agency are not undue (at 32). However, the costs considered in the Background Research Report are limited to the setup costs of the governance agency and the on-going annual costs including directors' compensation, liability insurance, board administrative costs and legal advice. The Background Research Paper estimates these costs from the costs of existing governance agencies in Canada where such have been established, and which total $4.2 million in aggregate (at 29).

It would have been informative to know how many governance agencies were considered in reaching this aggregate estimate. This would allow a rough estimate of the cost that an individual fund family might expect to bear absent the recommendations of the Concept Proposal.

Given its elements of the annual cost of running a governance agency, the Background Research Paper estimates that annual governance costs would increase by $65.9 million if all managers instituted governance agencies, absent the recommendations. To the extent that such elements fail to recognize the full costs associated with the type of governance agency contemplated in the Concept Proposal, the Background Research Paper provides a significant underestimate of the true costs of the proposed regime. Hence the savings in regulatory costs needed to significantly offset such cost increases will also be understated.

3. Cost Estimates Likely Understated

It is apparent that accountability of members of governance agencies to fund investors will be achieved through civil liability. The ability of investors to sue individual members and managers is not discussed at any length in the Concept Proposal, but it is a matter of considerable concern, especially in light of the availability of class action lawsuits.

In the United States, fund litigation is common, costly, and in the case of fee litigation, perhaps largely frivolous. In addition, as the *Krinsk* case indicates, non-specialized courts are poorly suited to understand and allocate overhead costs of fund management in order to determine whether the fund management fee is appropriate. The delays associated with litigation make accountability of governance agency members through civil liability even less satisfying.

To avoid exposure, members of governance agencies will undoubtedly seek to protect themselves with more legal opinions, special reports by experts such as the auditors, and greater demands on management than if civil liability did not attach. These are costs that are not faced by current governance agencies in Canada where they have been established because the members of those agencies do not have civil liability. Hence, the annual $75,000 cost estimate presented in the Background Research Report for independent legal advice at an existing governance agency is not a good indicator of such cost under the proposed regime.

A second source of additional costs apparently not considered is the opportunity cost of management time. The Background Research Report relies on an estimate of $30,000 annual cost of board operation and administration. Such figure does not recognize the implicit cost imposed on management to administer the governance agency, including the time and effort that will be needed to prepare for and attend meetings, recruit new members, produce on-going reports, implement board recommendations, and deal with litigation (both the frivolous and the serious) arising from civil liability of agency members.

Management time is valuable and can be devoted to a variety of other tasks that impact investors; obviously, it has a value that is many multiples of the pure board administrative cost figure. It is noteworthy that neither the Concept Proposal nor the Background Research Report make any mention of the diversion of management time due to the governance agency regime as a source of cost, and accordingly the true costs associated with the new regime are likely understated significantly.

The voluntary establishment of governance agencies by some managers, as noted in the Concept Proposal and the Background Research Paper, supports the inference that such costs are low. However, it cannot be assumed that the opportunity cost of management will remain low when the governance agency is made mandatory and when the agency can impose significant demands on management. Had the Background Research Report taken such costs into account, it is not clear that the Concept Proposal could have concluded that the cost burden is not undue.

It may be that, on a fuller conception of relevant costs, it is unrealistic to expect that significant offsetting cost reductions can be provided. If so, this calls into question a central issued identified by the CSA of accommodating the industry's demand for lower costs, while maintaining an adequate degree of investor protection.

4. Two Parallel Regimes?

Insofar as conventional mutual funds are concerned, the Concept Proposal would require the establishment of a governance agency where a fund company maintains the current trustee structure (at 23).

It is true that the trustee is not at present required to be independent of the fund manager. This question was addressed in the1969 Report of the Canadian Committee on Mutual Funds and Investment Contracts. The Committee was concerned that since trust companies also managed and sold mutual funds, the small number of trust companies in the market would force competitors to act as each other's trustee.

Although the fund trustee is not currently required to be independent, the imposition of fiduciary obligations under trust law makes it clear that the trustee's first obligation is to the investors. There is no evidence to suggest that this solution, albeit a superficially imperfect one, has been anything other than entirely successful.

The Stevens legal research paper makes it clear that the proposed governance agency is generally compatible with the role and function of the trustee. However, it does not address the fact that the governance agency and the trustee are both charged with the responsibility of protecting the interests of the fund investors. It is not clear how the functions of the two would differ.

Moreover, there may be a problem if the governance agency and the trustee disagree on a matter of fundamental importance. The Concept Proposal does not discuss the problem of who would prevail in such a situation: the trustee under trust law or the governance agency under civil law.

5. Governance Agency and the Retail Side

While the Concept Proposal notes certain tasks and responsibilities for the governance agency, the impression is that the agency will have considerable scope to monitor the activities of the manager. It is not clear whether the governance agency will, or indeed should, become involved with matters arising from the distribution of the funds it oversees. Yet it is in the area of abusive sales practices by third-party sales forces that virtually all of the documented abuses in the mutual fund business are to be found.

The Concept Proposal makes it clear that the governance agency will protect the interests of fund investors vis-à-vis management and that agency members will face civil liability. It appears to be silent on whether that liability extends to the retail side of the business and the to activities of the fund management company in its role as principal distributor. If so, the question arises whether members of the governance agency could be sued for failing to prevent abusive sales practices.

6. Selection of Independent Directors

The selection of independent members of governance agencies raises several issues.

i) As to the definition of independence, establishing a workable definition of an “unrelated director” is clearly a difficult matter. It appears, for example, that an independent member of a governance agency would fail the Concept Proposal’s unrelatedness test if he or she holds a significant investment in one or more of the managed funds. Moreover, it may be desirable to compensate such members with units or special units, which may further decrease independence according to the proposed definition.

The 1969 Report of the Canadian Committee discussed the difficulties of defining independence, and it questioned whether any suitably independent director would have the knowledge to pass judgment on management.

In the final analysis, the precise definition of independence is unlikely to make much difference in the selection of independent members of the governance agency. The practical test will, in all likelihood, become “the absence of obvious conflicts in the eyes of regulators” because any other definition will significantly limit the pool of qualified persons if it is applied strictly according to its terms.

ii) The Concept Proposal asks (at 25) whether the initial appointment of independent members of the governance agency by management creates “an insurmountable bias in favour of the fund manager” and it further questions the accountability of the governance agency if investors have no part in appointing directors.

The suggested bias in favour of management is also found in corporate governance where, typically, directors are nominated by management and confirmation by shareholders tends to be pro forma. Bias arises because shareholders in widely-held corporations lack the incentives individually to monitor management (the “free rider” problem). Nevertheless, corporate directors are accountable to shareholders who approve nominees by regular vote and who retain the right to nominate and replace corporate directors at regular annual meetings. While not frequent, shareholders do replace directors, and the availability of these shareholder rights imposes restraints on management.

However, these shareholder rights are apparently not to be given to fund investors. The manager will initially select the members of the governance agency and fund investors will have no involvement in their subsequent selection or removal, except perhaps in extreme cases. Accordingly, whatever incentive fund investors may have had to monitor management regularly is weakened further.

To date, the ease of exit through redemption on demand at marked-to-market net asset value has been the principal method by which fund investors monitor management. To the extent that this arrangement is successful, it cannot be said that the bias in favour of the fund manager is "insurmountable".

One consequence of the requirement to establish governance agencies and the imposition of civil liability on the members of those agencies is the encouragement of litigation as an alternative to exit, an outcome that is undesirable absent evidence of abuse that a governance agency has a particular advantage in preventing. But for the avenue of legal relief, it is hard to see how the governance agencies will be relevant to fund investors where easy exit is available.

It would have been highly appropriate for the CSA to present reasons why, in regard to conventional open-ended mutual funds, it views redemption on demand as inadequate. For example, studies comparing redemption rates between no-load funds and funds with back-end loads may indeed show that additional measures are needed. Similarly, the apparently large amount of investment in non-taxable accounts suggests that capital gains taxation may not be a significant restraint on redemption. However, these are matters for study. In the absence of any such evidence, it is difficult to conclude that redemption on demand has been anything other than highly effective in disciplining fund managers.

7. A Transfer of Regulatory Authority?

The following extract from the Erlichman Report highlights a conceptual matter that the Concept Proposal does not address:

> Fourth, depending upon the type of governance regime that is established, the existence of a governance regime might lead to the loosening of the conflicts rules relating to mutual funds, with the securities regulatory authorities relying on the governance mechanism to monitor transactions that otherwise would be prohibited or would require exemptions from existing securities laws. If this result occurs, then in effect there will be a transfer of some regulatory oversight from the CSA to the governance mechanism. (op. cit., at 3)

The more scope and authority granted to the governance agency, the greater is the deference to be accorded by securities regulators. There would be little reason (excepting cost savings) to mandate the type of governance agency suggested in the Concept Proposal if regulators were not prepared to routinely forbear in favour of the agency and litigation.

Canadian securities regulators should appreciate that the requirement for governance agencies establishes a very different role than they have traditionally had.

8. Alternatives, Generally

Management could, under suitable disclosure rules, make many of the decisions assigned to the governance agency, e.g. allocation of common costs among funds. If disclosure is the preferred method of dealing with fees, there is little rationale for requiring more complicated and costly machinery for dealing with matters that are less consequential, such as the allocation of common costs.

As the Concept Proposal notes (at 12-13), there are alternate means for protecting fund investors. In light of the absence of evidence of fund investor abuse by fund managers, it is very difficult to argue convincingly that, from the investors' perspective, one approach to fund governance reform is superior to any other or even to the status quo. Accordingly, there is a strong argument for allowing a variety of approaches to be adopted.

Thus, one fund family might retain the prevailing product-oriented approach and forego the reduction in regulatory requirements, while another might introduce a governance agency described by the Concept Proposal. Indeed, as long as the current degree of investor protection was maintained, there is much to be said for allowing experimentation and investor choice.

Uniformity may appear desirable from a regulatory perspective, but there is a cost to such enforced uniformity, in terms of reduced innovation by management and investor choice. In any case, there are bound to be differences in the governance of the various types of collective investment products such as conventional mutual funds, segregated funds, wrap accounts, etc.

Respectfully submitted,

Lawrence P. Schwartz