Barristers & Solicitors
Patent & Trade-mark Agents

McCarthy Tétrault

McCarthy Tétrault LLP
Box 48, Suite 4700
Toronto Dominion Bank Tower
Toronto ON M5K 1E6
Canada
Telephone: 416 362-1812
Facsimile: 416 868-0673
www.mccarthy.ca

7 June 2002

VIA DELIVERY

Ontario Securities Commission
20 Queen Street West
19th Floor
Toronto, Ontario M5H 3S8

Attention: John Stevenson, Secretary

Dear Sirs/Mesdames:

Re: Request for Comments on Concept Proposal 81-402 of the Canadian Securities Administrators

We are writing to provide comments on the Canadian Securities Administrators Concept Proposal 81-402 dated 1 March 2002 (the "Proposal").

Importance of Regulatory Presence Pillar

The Proposal outlines a profoundly new approach to a number of fundamental areas of mutual fund regulation referred to in the Proposal as "pillars". The pillars are identified as:

- registration for mutual fund managers;
- mutual fund governance;
- product regulation;
- disclosure and investor rights; and
- regulatory presence.

We have reservations respecting the extent to which it is possible to provide informed commentary on the Proposal. Although the first two pillars are outlined in the Proposal, the third and fourth pillars really consist of a request for proposals as to what form of regulation should be and the fifth pillar respecting regulatory presence is not addressed at all. We believe that in order to fully understand, and constructively comment on, the Proposal, it is necessary for interested parties to be presented with a complete Proposal. The absence of an articulation of regulatory direction, particularly with respect to pillars three, four and five, precludes the financial services industry from appreciating the relative significance, benefit

or disadvantage of the other pillars and hence their advisers from providing detailed legal analysis. For example, it is widely presumed that the implementation of the governance pillar will result in a dramatic reduction in the current body of regulation respecting related party transactions, and possibly, investment restrictions and unitholder meeting requirements applicable to retail mutual funds. In order to appreciate what the governance pillar will mean to the industry, we believe it is necessary to have a clear understanding of the regulatory pillar. The following fundamental questions remain unanswered by the Proposal:

1. What will the regulatory pillar require of the manager, the fund, and the governance agency?

2. Will each governance agency be able to devise its own proxy for the current regulatory framework that is expected to be relaxed or will common practices be imposed by the regulatory pillar?

3. Will the new regulatory pillar have parameters to ensure that governance agencies will not be able to adopt widely disparate approaches to fund governance?

4. The stated objective of the governance pillar is to improve mutual fund governance and implicitly to have the quality of governance in different fund complexes converge. How will this convergence take place without a regulatory pillar that imposes universal compliance practices?

5. What rationale underlies the need to regulate different financial products having different legal properties in a like fashion to mutual funds simply because they are offered to retail investors?

By way of example, we attach, as Schedule A, a copy of Rule 10f-3 under the *Investment Company Act of 1940* (the "1940 Act"). Rule 10f-3 is an exemption from the investment prohibition that is imposed upon U.S. investment companies by section 10(f) of the 1940 Act. Section 10(f) is the U.S. equivalent of section 4.1(1) of National Instrument 81-102. It is our understanding that Rule 10f – 3 is one of a number of rules which grant exemptive relief from requirements of the 1940 Act based, in part, upon the board of directors of an investment company having a majority of directors who are not interested persons of the investment company and who are authorized to select and nominate other disinterested directors of the company. As can be seen from the attached Rule 10f – 3, this particular condition is only one of a number of conditions of the exemptive relief that is granted by the rule. Furthermore, Rule 10f-3 clearly identifies the responsibilities of the board of directors as a whole, and not just the disinterested directors, as regards the exemptive relief that is available pursuant to Rule 10f –3. Accordingly, it has not been left to the disinterested directors of U.S. investment companies to fashion exemptive which they consider appropriate under the particular circumstances of their investment company presumably because such an approach could lead to a regulatory mosaic. As a result, we would expect the regulatory presence pillar to establish a similar comprehensive scheme of exemptive

relief which seeks to promote procedural uniformity for all mutual funds. An understanding of the regulatory presence pillar is therefore critical to an understanding of the other four pillars and we therefore find it difficult to provide informed commentary on the latter in the absence of the former.

Registration of Mutual Fund Managers

We do not believe that the new registration category should be forced upon mutual fund managers that are already registered as dealers or advisers under Canadian securities legislation. Where the manager is already registered in one of these categories, we believe there is adequate regulatory oversight over the manager. Registration as a mutual fund manager would be an unnecessary duplication of regulatory cost.

Product Regulation

We believe that the traditional exempt market should remain exempt. The direction of future securities regulation should not try to level the regulatory playing field as between retail mutual funds and other collective investment products that are offered strictly to accredited investors or otherwise pursuant to available registration and prospectus exemptions.

Mutual Fund Governance

The role of the governance agency needs to be further articulated and we offer the following observations:

1. Arguably the governance agency will disenfranchise or render obsolete existing supervisory structures thus causing or requiring a major structural shift in the existing legal structures.

2. The attempt to limit the governance agency to "oversight" and not "management" is perhaps laudable but in practice this is a continuum and therefore will mandate (as opposed to permit) a shift of fund management prerogatives from existing structures to the new governance agency. In the context of entities such as banks and insurers with existing governance systems, this appears to be over-regulation.

3. At a technical level, the "role" of the governance agency is expressed in terms which will inevitably cause confusion. In both the *Canada Business Corporations Act* and the *Business Corporations Act* (Ontario), the core duty of a board of directors is "manage or supervise the management of the Corporation". This articulation of directors duties is based on more than three centuries of common law corporate governance. To make the governance agency's mandate the same in legal terms as a board of directors will lead to no clear result unless it is intended to fully expropriate the management prerogatives of the existing structures in whatever form they take.

4. It is implicit in the governance agency concept that the mutual fund manager – unless owned by investors – must be "monitored" in each and every aspect of its activities. This is certainly a debateable issue.

5. Under the terms of the Proposal the fundamental question that arises is "Who is management?" Presumably, it is not intended to encapsulate the governance agency. Yet once oversight and authority are vested in the governance agency, the question of who is management becomes unclear.

6. While corporate governance models – e.g. TSX guidelines – require independent directors to be incorporated into the management structure, they do not in effect create a rival to management.

7. Finally, we are concerned that the Proposal could result in the Canadian securities regulatory authorities ("CSRA") effectively abdicating regulatory responsibility for some rather difficult regulatory issues because it makes no reference to the extent of the CSRA's continued involvement if and when the Proposal is implemented. The Proposal refers to the fact that the CSRA has generally responded to potential conflicts of interest by simply prohibiting certain relationships or transactions by mutual fund managers, because although they have broad discretion to grant relief from such prohibitions, their discretion has been exercised only in narrow circumstances.[1] Accordingly, in the absence of the CSRA's continued involvement, it is difficult to understand why a governance agency would be prepared to be more accommodating than the CSRA has been in the past respecting conflicts of interest and other issues.

We would be pleased to provide further submissions regarding any aspect of the foregoing.

Yours very truly,

McCarthy Tétrault

---

[1] *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers,* Concept Proposal of the Canadian Securities Administrators, March 1, 2002, p. 10.

The Securities Lawyer's Deskbook

Currentness
Search Page
Suggestions

Schedule A

General Rules and Regulations promulgated under the Investment Company Act of 1940

Rule 10f-3 -- Exemption for the Acquisition of Securities During the Existence of an Underwriting or Selling Syndicate

a. Definitions.--

1. Domestic Issuer means any issuer other than a foreign government, a national of any foreign country, or a corporation or other organization incorporated or organized under the laws of any foreign country.

2. Eligible Foreign Offering means a public offering of securities, conducted under the laws of a country other than the United States, that meets the following conditions:

   i. The offering is subject to regulation by a "foreign financial regulatory authority," as defined in section 2(a)(50) of the Act, in such country;

   ii. The securities are offered at a fixed price to all purchasers in the offering (except for any rights to purchase securities that are required by law to be granted to existing security holders of the issuer);

   iii. Financial statements, prepared and audited in accordance with standards required or permitted by the appropriate foreign financial regulatory authority in such country, for the two years prior to the offering, are made available to the public and prospective purchasers in connection with the offering; and

   iv. If the issuer is a Domestic Issuer, it meets the following conditions:

      A. It has a class of securities registered pursuant to section 12(b) or 12(g) of the Securities Exchange Act of 1934 or is required to file reports pursuant to section 15(d) of the Securities Exchange Act of 1934; and

      B. It has filed all the material required to be filed pursuant to section 13(a) or 15(d) of the Securities Exchange Act of 1934 for a period of at least twelve months immediately preceding the sale of securities made in reliance upon this (or for such shorter period that the issuer was required to file such material).

3. Eligible Municipal Securities means "municipal securities," as defined in section 3(a)(29) of the Securities Exchange Act of 1934, that have received an investment grade rating from at least one NRSRO; provided, that if the issuer of the municipal securities, or the entity supplying the revenues or other payments from which the issue is to be paid, has been in continuous operation for less than three years, including the operation of any predecessors, the securities shall have received one of the three highest ratings from an NRSRO.

4. Eligible Rule 144A Offering means an offering of securities that meets the following conditions:

   i. The securities are offered or sold in transactions exempt from registration under section 4(2) of the Securities Act of 1933, rule 144A thereunder, or rules 501-508 thereunder;

   ii. The securities are sold to persons that the seller and any person acting on behalf of the seller reasonably

believe to include qualified institutional buyers, as defined in rule 144A(a)(1) of this chapter; and

iii. The seller and any person acting on behalf of the seller reasonably believe that the securities are eligible for resale to other qualified institutional buyers pursuant to rule 144A of this chapter.

5. NRSRO has the same meaning as that set forth in rule 2a-7(a)(14).

b. Conditions. Any purchase of securities by a registered investment company prohibited by section 10(f) of the Act shall be exempt from the provisions of such section if the following conditions are met:

1. Type of Security. The securities to be purchased are:

i. Part of an issue registered under the Securities Act of 1933 that is being offered to the public;

ii. Eligible Municipal Securities;

iii. Securities sold in an Eligible Foreign Offering; or

iv. Securities sold in an Eligible Rule 144A Offering.

2. Timing and Price.

i. The securities are purchased prior to the end of the first day on which any sales are made, at a price that is not more than the price paid by each other purchaser of securities in that offering or in any concurrent offering of the securities (except, in the case of an Eligible Foreign Offering, for any rights to purchase that are required by law to be granted to existing security holders of the issuer); and

ii. If the securities are offered for subscription upon exercise of rights, the securities shall be purchased on or before the fourth day preceding the day on which the rights offering terminates.

3. Reasonable Reliance. For purposes of determining compliance with paragraphs (b)(1)(iv) and (b)(2)(i) of this section, an investment company may reasonably rely upon written statements made by the issuer or a syndicate manager, or by an underwriter or seller of the securities through which such investment company purchases the securities.

4. Continuous Operation. If the securities to be purchased are part of an issue registered under the Securities Act of 1933 that is being offered to the public or are purchased pursuant to an Eligible Foreign Offering or an Eligible Rule 144A Offering, the issuer of the securities shall have been in continuous operation for not less than three years, including the operations of any predecessors.

5. Firm Commitment Underwriting. The securities are offered pursuant to an underwriting or similar agreement under which the underwriters are committed to purchase all of the securities being offered, except those purchased by others pursuant to a rights offering, if the underwriters purchase any of the securities.

6. Reasonable Commission. The commission, spread or profit received or to be received by the principal underwriters is reasonable and fair compared to the commission, spread or profit received by other such persons in connection with the underwriting of similar securities being sold during a comparable period of time.

7. Percentage Limit. The amount of securities of any class of such issue to be purchased by the investment company, or by two or more investment companies having the same investment adviser, shall not exceed:

i. If purchased in an offering other than an Eligible Rule 144A Offering, 25 percent of the principal amount of the offering of such class; or

ii. If purchased in an Eligible Rule 144A Offering, 25 percent of the total of:

A. The principal amount of the offering of such class sold by underwriters or members of the selling syndicate to qualified institutional buyers, as defined in rule 144A(a)(1) of this chapter, plus

B. The principal amount of the offering of such class in any concurrent public offering.

8. Prohibition of Certain Affiliate Transactions. Such investment company does not purchase the securities being offered directly or indirectly from an officer, director, member of an advisory board, investment adviser or

employee of such investment company or from a person of which any such officer, director, member of an advisory board, investment adviser or employee is an affiliated person; provided, that a purchase from a syndicate manager shall not be deemed to be a purchase from a specific underwriter if:

i. Such underwriter does not benefit directly or indirectly from the transaction; or

ii. In respect to the purchase of Eligible Municipal Securities, such purchase is not designated as a group sale or otherwise allocated to the account of any person from whom this paragraph prohibits the purchase.

9. Periodic Reporting. The existence of any transactions effected pursuant to this section shall be reported on the Form N-SAR of the investment company and a written record of each such transaction, setting forth from whom the securities were acquired, the identity of the underwriting syndicate's members, the terms of the transaction, and the information or materials upon which the determination described in paragraph (b)(10)(iii) of this section was made shall be attached thereto.

10. Board Review. The board of directors of the investment company, including a majority of the directors who are not interested persons of the investment company:

i. Has approved procedures, pursuant to which such purchases may be effected for the company, that are reasonably designed to provide that the purchases comply with all the conditions of this section;

ii. Approves such changes to the procedures as the board deems necessary; and

iii. Determines no less frequently than quarterly that all purchases made during the preceding quarter were effected in compliance with such procedures.

11. *Board Composition, Selection, and Representation:*

i. A majority of the directors of the investment company are not interested persons of the company, and those directors select and nominate any other disinterested directors of the company; and

ii. Any person who acts as legal counsel for the disinterested directors of the company is an independent legal counsel.

12. Maintenance of Records. The investment company:

i. Shall maintain and preserve permanently in an easily accessible place a written copy of the procedures, and any modification thereto, described in paragraphs (b)(10)(i) and (b)(10)(ii) of this section; and

ii. Shall maintain and preserve for a period not less than six years from the end of the fiscal year in which any transactions occurred, the first two years in an easily accessible place, a written record of each such transaction, setting forth from whom the securities were acquired, the identity of the underwriting syndicate's members, the terms of the transaction, and the information or materials upon which the determination described in paragraph (b)(10)(iii) of this section was made.

Previous Contents Next

Published for the Center for Corporate Law by the Center for Electronic Text in the Law