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Canadian Securities Administrators
c/o John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

-and -

Denise Brousseau, Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square, Stock Exchange Tower
P. O. Box 246, 22nd Floor
Montreal, Québec H4Z 1G3

Dear Sirs and Mesdames:

Re: Comments on Mutual Fund Governance Proposal - Concept Proposal 81-402 (the "Concept Proposal")

The following comment raises some issues concerning shareholder rights and the voting of mutual fund portfolio shares. It should be relevant to Questions 36 and 38 in your concept proposal. I sincerely welcome any comments and insight.

The Voting of Mutual Fund Portfolio Shares in Canada: A Brief Overview of some Legal Considerations

INTRODUCTION

The following outline examines the law pertaining to the voting of mutual fund portfolio shares in Canada. The focus of the discussion centers around potential limitations on the actions of persons responsible for administering the fund as well as the legal relationship between these persons and the investor. The first section briefly discusses the importance of the mutual fund organizational structure when attempting to identify the individuals that are burdened with duties

towards the investor, while the second section of the discussion addresses potential sources and content of these duties.

MUTUAL FUND ORGANIZATION

Mutual funds are commonly structured in two ways: as trusts or as corporations.[1] For present purposes, it is important to distinguish between the two, as the structure will determine which individual, if any, has obligations to the investor. For instance, in the case of a trust, the trustee normally bears the obligations, while in the case of a corporate structure, the corporation (and not the management) *potentially* has some responsibility.[2] Therefore, a reasoned analysis must begin by first identifying the various individuals involved and only afterwards proceeding to determine whether or not there is a duty owed to the investor.

In addition to determining whether particular individuals owe any duties, the structure of the fund can also dictate the types of remedies available and the procedure that must be followed. For instance, if the mutual fund is structured using a corporation and the investor is a shareholder, several statutory mechanisms – such as shareholder proposals or oppression remedies- can potentially come into play. These types of remedies typically extend beyond the shareholder/corporation relationship and include management and other persons, who would otherwise be unreachable. As well, depending on the structure, the actions of the individuals administering the fund may expose them to liability for statutory offences in addition to any civil causes of action. For example, the CBCA makes it an offence for *anyone* to contravene its provisions.[3] If statutory offences are applicable, it is important to identify the repercussions of such a breach, as sometimes the investor may have direct recourse, such as under the CBCA,[4] while in other cases enforcement of the statutory provisions must be left to the appropriate government officials.

While a detailed analysis of the various types of fund structures is beyond the scope of this brief, throughout the rest of this discussion it is important to keep in mind how each of the following sources of obligations potentially interact with the organizational structure of the fund. Since a significant number of individuals can be involved in any one given situation –including investors, fund administrators, independent fund management, and issuers of securities- keeping track of the duties and obligations of each becomes essential.

SOURCES OF OBLIGATIONS

Considering that transactions involving mutual funds can be numerous and complex, it is unsurprising that there is no single body of law that governs the behaviour of fund administrators. Instead, most of the constraints come from several different sources, with substantial overlap and interaction. At least four potential sources of obligations pertaining to mutual funds can be identified: i) contractual obligations ii) statutory obligations arising from provincial securities legislation and national policy statements[5], iii) statutory obligations arising from company incorporation legislation, including provincial, federal, and foreign legislation,

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[1] See M. Gillen, *Securities Regulation in Canada*, (Toronto: Thomson Canada Ltd., 1998) [hereinafter SRC] at 458. Both are equally popular in Canada. Usually for investors, the only difference concerns tax issues. Also note that NP#39 was recently replaced by NI 81-102.

[2] Note that normally a corporation does not owe a duty to its shareholders. However, depending on the particular circumstances, it is arguable that a fiduciary relationship exists between a mutual fund corporation and its shareholder/investors due to the unique circumstances that surround their involvement. As well, the same principle applies to directors and shareholders, depending on what representations have been made.

[3] See CBCA s.251 for a blanket provision.

[4] See CBCA s.247, the restraining and compliance remedy. This is in addition to any charges that could be laid.

[5] Although the National Policy statements are not "law", they are nevertheless followed and enforced.

and iv) common law and equitable duties arising from the nature of the relationship between the individuals involved.

i) Contractual Obligations

Many different contracts potentially bear on mutual fund transactions. For the present discussion, possibly the most important one that limits the operation of the fund is the initial contract between the investor and the fund administrator. The terms of these contracts can vary widely and are usually tailored for the specific fund in question, with common terms addressing how the fund will be structured, what types of securities the fund will hold, and how the investor will be compensated.

The various forms of investor/mutual fund administrator contracts will not be addressed in this brief, but it is important to realize that there are important limits as to what can be contracted. For instance, it is unlikely that statutory obligations can be circumvented and any terms purporting to do so would be invalid.[6] However, this is probably a rare occurrence and more commonly the terms are broadly worded and do not address highly specific situations, such as the voting of portfolio shares. An example can be found in a BMO Simplified Prospectus, where the role and duties of the trustees is described as follows: "The trustees hold title to the securities owned by those funds on behalf of unitholders, have exclusive authority over their assets and affairs and have a fiduciary responsibility to act in the best interest of the unitholders."[7] The specifics as to what the "fiduciary responsibility" entails are left undefined, and whether or not disclosure of voting patterns to investors is required remains unclear.[8] In addition, it should be noted that while contractual terms, such as the above example, can echo the equitable principle of fiduciary duty, any purported breach is based in contract and remains separate from any additional common law/equitable action that may be available. Therefore, terms such as the above go beyond merely restating the relationship with the investor and inadvertently provide investors with some certainty as to their legal relationship with the trustees[9] and provide more avenues for recourse[10].

ii) Securities Legislation and National Policy Statements

Securities regulation in Canada is a highly complex area of law. It involves many intricacies that require detailed analysis before conclusions can be drawn. However, the following discussion should serve to outline some basic considerations that should be taken into account when determining what limitations securities regulation imposes on the voting of portfolio shares.

Presently, throughout Canada there seem to be no legislative or policy provisions that explicitly address disclosure of mutual fund portfolio voting practices. However, there are some disclosure requirements that usually take the form of a Simplified Prospectus.[11] The information included is presented in plain language and is quite informative, generally including information regarding the structure and operation of the fund, as well as tax implications for investors. In addition to the Simplified Prospectus other documents, such as the Annual Information Form[12], Pro-forma Simplified Prospectus, and Pro-forma Annual Information Form, [13] are potential

[6] This depends on the particular statute and whether contracting out is permitted.
[7] See BMO Simplified Prospectus at 146 (available at http://www.bmo.com/mutualfunds/pdfs/).
[8] What a "fiduciary relationship" involves will be further discussed under the section: iv) Common Law/Equitable Duties.
[9] I.e.: a fiduciary relationship is clearly identified and does not have to be argued.
[10] Such as suing *both* in contract and in tort. Recall that suing in tort requires the burden of proving negligence while in contract only a breach must be shown and fault is irrelevant. However, exculpatory clauses may come into play.
[11] SRC, supra note 1 at 467.
[12] Ibid. at 469.
[13] Ibid. at 470.

sources of information. At the present time, most (if not all) major Canadian mutual fund providers do not disclose the voting practices regarding fund securities in these documents.[14]

Despite this, provincial securities legislation, such as Ontario's *Securities Act*, can place limits on the positive act of voting the portfolio shares (as opposed to disclosure of voting practices). For instance, s.49 of Ontario's act provides that securities registered in the name of a registrant or custodian, but not beneficially owned by these persons, shall not be voted unless voting instructions are received from the beneficial owner. Depending on how these provisions are interpreted, there is the possibility that voting portfolio shares requires explicit instructions from the investor. It should be noted that the various incorporating statutes that govern how the particular securities held in a fund can be voted closely parallel these types of voting restrictions. This will be further discussed in the following subsection (company incorporation statutes).

In addition to direct limitations on voting, a potential restriction that can indirectly control the voting of mutual fund shares arises from the investment requirements, restrictions, and practices that are outlined in the National Policy statements. These provisions address conflict of interest situations[15] and investment restrictions[16]. Of importance to the present discussion are the investment restrictions. Generally, limits are placed on the amount and type of securities that a can be held in a mutual fund. For instance, mutual funds are prohibited from containing more than 10% of a class of securities of an issuer, and funds are also prohibited from containing securities if the purpose is to exercise control or management of an issuer.[17] While these provisions do not address voting practices directly, they limit the relative *influence* of voting the fund's shares and limit the *purpose* for which the securities can be acquired. However, there seems to be little preventing several fund organizations from acting in unison to exert a greater amount of influence over a particular company, as long as the securities were not initially purchased for this purpose. If this situation arose, separate provisions (under each province's securities legislation) regarding "solicitation" of proxy votes, which is broadly defined, *may* arguably come into play, in which case a certain amount of public disclosure would be required.[18]

iii) Company Incorporation Statutes

The securities held in a fund normally come from diverse issuers. The respective incorporating statute governs the voting of shares that are being held of each corporation.[19] When the mutual fund shares are voted, the various provisions must be adhered to. Since the provisions can significantly vary between statutes, the requirements for each corporation should be examined independently. Since funds usually contain shares from a significant number of companies, both national and international, this presents a formidable task. As well, special attention should be paid to the various terminology and definitions that are used, as the same word or phrase usually has different meaning from statute to statute.[20] Here, only CBCA corporations will be discussed.

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[14] Only several of the major funds were checked on the Internet. There was no mention of voting practices in the prospectuses of their mutual funds. Probably the same can be said of other Canadian mutual funds.

[15] SRC, supra note 1 at 471.

[16] Ibid. at 474.

[17] Ibid. at 474-475. See also NI 81-102, sections 2.1 and 2.2.

[18] See SRC, supra note 1 at 180-182. Whether or not the provisions would come into play depends on several factors, including whether or not proxy votes (as opposed to simply direct voting) are required, and whether the "solicitation" may *potentially* involve proxy votes. Also the relevant provisions under incorporating statutes should be examined, such as CBCA ss.147-154, which mirror the securities legislation provisions.

[19] This should not to be confused with the structure surrounding the mutual fund (i.e.: trust or corporation). Here we are discussing the issuers of securities that are being held in the fund.

[20] For instance, the term "beneficial ownership" is used in both securities legislation and corporate legislation. In the case of the CBCA, the term is explicitly defined in the statute.

Under the CBCA, "beneficial ownership" is broadly defined as including ownership through any trustee or other intermediary.[21] This likely includes investors that deal with both trust and corporate mutual funds, and would therefore include the investors as beneficially owning the securities of the CBCA corporation that were being held in the mutual fund. In addition, the administrator of the mutual fund is likely not considered a beneficial owner of the securities held and is probably considered an "intermediary".[22] Depending on how the particular mutual fund administrator and investor fit within these definitions, the recently amended CBCA s.153 may prohibit the fund administrator from voting shares of a CBCA corporation unless disclosure is given to investors and written voting instructions are obtained.[23] Presumably, this applies every time that a vote takes place and cannot be waived once and for all by the investor at the outset of the relationship.[24] However, if under the CBCA mutual fund organizations are considered to directly own and benefit from the securities that they hold (i.e.: the mutual fund companies are not considered to be intermediaries and the investors are not considered beneficial owners), then the usual rules pertaining to voting apply and investors have no involvement with the process.[25]

In the case where the above definitions allow the investor to have a say as to how the mutual fund shares will be voted, the additional problem of dividing up the rights attached to the shares arises. Considering the diversity of mutual funds and the number of investors, it becomes difficult to divide the share votes between the investors while keeping the votes "whole". Fractional votes are not allowed[26] and presumably the investors must sort out among themselves as to how a single vote per share will be cast.[27] With a large number of investors scattered throughout the world, reaching consensus is unlikely.

iv) Common Law/Equitable Duties

So far only statutory provisions that limit the actions of the administrators of a mutual fund have been discussed. In addition to these statutory limits, complimentary common law and equitable duties are applicable. These depend upon the relationship between the particular individuals involved and care must be exercised to clearly identify which persons are owed obligations and by whom. In general, since fund securities are being held in trust for the benefit of the investor[28], the trustees have all the usual obligations of fiduciaries. This not only includes a duty to act in the best interests of the investor,[29] but also includes a *positive* obligation to disclose all pertinent information regarding a transaction.[30] In the case of voting mutual fund shares, in all likelihood the obligation to disclose includes the duty to actively notify the investor of the voting practices. At minimum, if the investor requests this information, it must be readily available. Since mutual fund investors are typically unsophisticated when it comes to investment

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[21] See CBCA definition under s.2(1). Also recall the contractual term mentioned in the text concerning the BMO trustee obligations, supra note 7.
[22] The word "intermediary" is defined broadly under CBCA s.147 and probably includes a trust and corporate mutual fund organization. See especially s.147(g).
[23] See CBCA s.153(1),(2),(7).
[24] S.148(3) only addresses the validity of a *proxy*. However, s.153(1) requires *both* disclosure of information to the beneficial owner and written instructions. While blanket voting instructions are arguably possible, it can be reasonably inferred from the wording that disclosure of information is required for every vote. The CBCA does not provide for contracting out of the disclosure requirement.
[25] See CBCA s.140.
[26] See CBCA s.140(4).
[27] This situation is not addressed in the CBCA. I suggest default would be consensus rather than majority.
[28] In the case of a corporate structure, at minimum, the securities are held in a trust-like arrangement (due to the representations made to the investor at the outset) and the same rules should apply.
[29] Recall also the BMO contractual term mentioned in the text, supra note 7.
[30] For an example, see *Ocean City Realty Ltd. v. A&M Holdings Ltd*., 36 DLR 4th 94. See also M. Ellis, *Corporate and Commercial Fiduciary Duties*, (Toronto: Thomson Publishing, 1995), Ch.1, sections 1-4, and in particular 4(2)(d). How shares are voted is undeniably "material" to the investor.

practices, the fiduciary obligations are probably set to a high standard. Nevertheless, most (if not all) mutual funds in Canada do not disclose this information.[31]

CONCLUSION

When it comes to the voting of mutual fund shares, both statutory and common law/equitable limitations come into play. There are potentially both direct limits concerning voting practices (such as the voting of CBCA corporate shares) and indirect limits (such as limits on fund content) that must be adhered to. As well, fiduciary duties owed to the investor must be discharged. Presently, the voting practices of mutual fund shares are not disclosed to investors and *if the above analysis is correct*, the legality of this is questionable. However, the choice of remedy involves complexities and costs that the normal mutual fund investor would probably want to avoid, hence the ideal way to address this issue would seem to be through government intervention.

[31] See supra, note 14.