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July 19, 2002

VIA E-MAIL

Mr. John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
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Toronto, Ontario
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- and -

Ms. Denise Brousseau
Secretary
Commission des valuers mobiliéres du Québec
800 Victoria Square
Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Québec
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Dear Sirs/Mesdames:

Re: Concept Proposal 81-402

We welcome the opportunity to provide our comments to the Canadian Securities Administrators (the "CSA") on Concept Proposal 81-402 – *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers, March 1, 2002* ("CP 81-402").

For your information, our response sets forth the views of our Investment Funds Group and not those of our clients, and intentionally does not include the views of Stephen Erlichman, a senior partner at our firm, who prepared the paper for the CSA in June 2000 entitled *Making it Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada*.

Our response to certain of the issues posed for comment by the CSA in CP 81-402 are set out below.

Issue 1. 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?

Although we are not entirely convinced that it is necessary to revise the existing regulatory regime governing mutual funds, we agree that CP 81-402 should allow for greater flexibility in mutual fund regulation than is currently the case. Before proceeding empirical evidence should be obtained confirming the benefits of independent governance agencies. Furthermore, we are concerned that enhanced flexibility will not be achieved unless and until the current detailed and prescriptive regulation of related-party transactions is liberalized. We share the view expressed by other commentators that if changes are made to the existing regulatory regime, certain elements of the related-party rules should be liberalized at the same time.

Issue 4. Which parts of the renewed regulatory framework should be extended or not extended to other investment vehicles – and which investment vehicles? Why do you believe that 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?

We do not believe the regulatory framework of CP 81-402 should extend to pooled funds which are only offered to sophisticated purchasers as such products are generally exempt from the requirements of applicable securities legislation, on the basis that such purchasers do not need the protection of the applicable securities legislation.

We also do not believe that the proposed regulatory framework should apply to closed-end funds that are listed on stock exchanges. Such funds are not in continuous distribution and investors in such funds typically do not rely on a redemption feature to exit from the fund.

Issue 7. 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.

We agree with other commentators who are of the view that a due diligence defence for members of the governance agency should be provided for.

Issue 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?

We believe and it is our experience that sufficient duplication of function and content exists such that a governance agency should be allowed to supervise such number of mutual funds as it considers appropriate in the circumstances. We also are of the view that the CSA should provide specific and detailed guidance to the industry as to the scope of oversight that is to be provided by governance agencies. If the CSA does not do so, we believe there will be an undue lack of consistency in terms of the supervisory role played by governance agencies.

Issue 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?

The definition of independent members of the governance agency makes sense to us. Such definition presumably will exclude members of the law firm that provides legal advice to a fund manager or an affiliate thereof. In order for a governance agency to properly perform its supervisory function, it will need to obtain considerable input and information from the manager of the mutual fund(s) in respect of which it is acting. Accordingly, we agree that the majority (not all) of the members of the fund governance agency should be independent.

Issue 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?

CP 81-402 provides that governance agency members will be obliged to act in the best interests of investors. Accordingly, we believe it is important and crucial to fulfilling that role that the governance agency monitor the investment performance of the mutual funds in respect of which it is acting. We also believe that the governance agency should review and approve the disclosure documents of the relevant mutual funds.

***Issue 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?**

Although we do not oppose the idea of the governance agency approving policies on the use of derivatives and other types of investments, we do not believe that this is necessary. It may be better if the manager and/or investment manager of a fund is responsible for such policies as they have the relevant expertise to judge if such policies and procedures are appropriate.

***Issue 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 deferred from sitting on governance agencies?**

We have no doubt that potential qualified members for governance agencies will be deterred from sitting on such agencies unless their liability is limited in some way. We agree with those who suggest that a statutory due diligence defence should be included in CP 81-402. It may be beneficial to consider a statutory business judgement rule as well. We also believe that full indemnity and insurance for the benefit of agency members should be provided and paid for by the relevant mutual funds.

***Issue 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.**

We believe the concerns expressed with regard to fund managers appointing the initial governance agency members to be real. However, we do not believe that the cost of convening investor meetings justifies having securityholders vote on the initial appointment of such members. The key issue for governance agency members will always be independence. We believe that it would be appropriate for each independent agency member to be obliged to certify that he or she is, in fact, independent from the fund manager, and that such member should renew and confirm such certification on an annual basis, and that such confirmation should be communicated to the securities regulators and investors.

***Issue 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?**

We do not believe that investors who do not like who has been elected or appointed as a member of the governance agency should be able to sell their securities of a fund without

penalty. The policies being considered in CP 81-402 are for the benefit of all investors, and should not detrimentally affect their investment in the fund. As a result, it seems inappropriate to give an investor the ability to redeem their securities without any resulting cost consequences. In addition, we believe that the CSA should publish non-binding guidelines for the qualifications of prospective members of a governance agency.

Issue 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?

We believe that the mutual fund manager should provide information to the governance agency members regarding industry standards of compensation paid to members of governance agencies, and make a non-binding recommendation to the governance agency as to the fees to be paid thereto. We agree that the fund manager should not be given a veto power in relation to such compensation, but that it should have the ability to call a special meeting of investors to review any compensation of the governance agency that the fund manager believes is unreasonable.

Issue 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.

In the event of a vote by investors on a resolution brought forward by the governance agency to terminate a fund manager, investors that are "related" to the fund manager should not be allowed to vote. Has the CSA considered mandating the involvement of the principal regulator in the scenario where the fund governance agency has brought forward a resolution to terminate the fund manager? Given the general apathy of investors in relation to securityholder meetings, reliance on an investor vote to decide this crucial issue may be less than meaningful. Accordingly, it may be necessary for the CSA to be involved in the decision as to whether it is appropriate in the circumstances to terminate the fund manager pursuant to a resolution brought forward by the governance agency.

Issue 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?

We agree with the suggestion that the fund manager should have the ability to call a securityholder meeting to consider removing a particular non-performing member of the governance agency. We also agree that a majority of the governance agency should also have this power. In addition, it may be worthwhile to ensure that a certain percentage of the investors in a fund (e.g., five percent) have the ability to call a meeting to consider removing such an individual.

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

As noted in relation to Issue 21 above, we believe that investors should receive an annual confirmation from the independent members of a fund governance agency that they are, in fact, "independent".

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

We believe 12 to 24 months would be an appropriate transition period.

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

We believe IFIC should be asked to develop a training program for prospective fund governance agency members, with an emphasis on ensuring that such individuals understand mutual funds and how they are regulated, including conflict of interest concerns.

Issue 29. What are your views on the 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 more interested in your views on our proposals about the conditions of registration of fund managers.

We agree that the registration of mutual fund managers is appropriate, but suggest that registration as a mutual fund manager, adviser and mutual fund dealer be kept separate and distinct. In addition, we would suggest that registration as a mutual fund manager should only be required in the manager's principal jurisdiction and should not be required province by province. Furthermore, each category of registration should have its own

registration requirements with sufficient flexibility to accommodate unusual situations. The CSA will also need to consider the cost implications of registration (i.e., will each category of registration have its own fees which are cumulative if a person is registering in more than one capacity?) to ensure that they do not act as a barrier to entry for qualified participants.

Issue 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 the 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?

Although we agree that the primary function of the governance agency should be to oversee the management of the mutual funds, and not to assess the adequacy of senior management and the directors of the fund manager, we are concerned that the governance agency will do just that. Nonetheless, we agree that primary responsibility for assessing the adequacy of senior management and the directors of the fund manager should rest with the CSA, with such assessment being conducted through the registration system. We believe that the assessment by the governance agency of the qualifications of the management of the fund manager will in effect act as a secondary check on such individuals with a different, more practical emphasis.

We note that paragraph 2.2.1 of CP 81-402 contemplates that each mutual fund manager has four senior management positions. For start-up and smaller mutual fund management companies, we recommend that a suitably qualified individual should be allowed to be responsible for more than one position.

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

We appreciate the concern about ensuring that the mutual fund manager has adequate capital to satisfy its obligations. All three options suggested have their merits, but the simplicity of Mr. Erlichman's recommendation may make it the preferred choice. Our

only concern with all three options is that the minimum capital requirement needs to be chosen carefully as it may be difficult for a start-up or small mutual fund family to satisfy, and may effectively drive niche players out of business.

Issue 33. Is our list of essential 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?

Although we agree that the various internal control procedures of a mutual fund complex should be reviewed on a regular basis, we are concerned that in many instances some of these functions may actually be carried out by the trustee of the fund and not by the manager. As a result, it may not be appropriate to impose these obligations on the fund manager.

Issue 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?

A Section 5900 Report may be useful, but we query if this should be a mandated requirement. It imposes an additional cost on the fund and is probably not necessary given the roles of the governance agency, the mutual fund manager and the CSA in monitoring the activities of a mutual fund complex.

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

An example is provided in paragraph 2.2.8 to the effect that fund managers will be required to have staff with such knowledge, expertise and experience so that they may adequately supervise third party portfolio managers. We wonder about the exact details and meaning of this. Will fund managers be required to have a CFA on staff? If the answer to this question is "yes", we believe this may be an unduly onerous requirement, especially for start-up fund management companies.

Issue 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?

We believe that detailed empirical work must be conducted by or on behalf of the CSA in relation to the current related-party rules, to identify issues, abuses (if any), and to assess the negative impact (if any) of such rules on public mutual funds in Canada. We do not believe that the related-party rules should be liberalized and the regulation of related party transactions delegated by the CSA to fund governance agencies without such empirical work first being conducted.

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

If responsibility for related-party transactions is delegated to a mutual fund's governance agency, the governance agency must have detailed policies and procedures to govern their scrutiny of same. If such policies and procedures are in place, we believe that the governance agency can supervise such related-party transactions by asking for assurances on a regular basis that there has been compliance with such policies and procedures.

Issue 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?

We agree that fund governance agencies should be given the right and obligation to review and approve any proposed changes in the auditors of the mutual funds that they are supervising. We are also of the view that a proposed change of manager, other than to an affiliate, should be approved by the mutual fund's governance agency and the securityholders of the fund.

* * *

Thank you for giving us this opportunity of providing you with our comments on CP 81-402. Our apologies that these comments are being submitted so late. Mutual fund governance is an extremely important issue and we look forward to commenting on the next draft of the proposal.

If you have any questions or if we can be of any assistance, please do not hesitate to contact Mr. David Moritsugu at 416 868 3484 or Mr. Garth Foster at 416 868 3422.

Yours truly,

Fasken Martineau DuMoulin LLP