April 6, 2004

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th floor, Box 55
Toronto, Ontario
M5H 3S8

Denise Brousseau, Secretary
Autorité des marchés financiers
800, Square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal, Québec
H4Z 1G3

Dear Mr. Stevenson and Ms. Brousseau:

Subject : CSA National Instrument 81-107 (NI 81-107) [1]
Independent Review Committee for Mutual Funds

The Small Investor Protection Association (SIPA) welcomes the opportunity to comment on these proposals, however the request to do so seems disingenuous given the fact that the CSAs have implemented the proposals via exemption orders devoid of public comment and debate. We have grave concerns about the substance of the proposals and the CSA's process, both of which undermine investor protection.

In our view, the *primary* purpose of securities regulations and regulators is to protect investors. It is in this context that we will examine NI 81-107.

A. Summary of Proposal – Our Understanding

National Instrument 81-107 requires each fund manager to set up an Independent Review Committee (IRC) to look at real and potential conflicts involving the manager's commercial or business interests and its fiduciary obligations to the funds it manages for a fee. These inherent conflicts involve related party conflicts, personal conflicts (e.g. bonus, promotion) and business (profit driven) conflicts. There is no reference to the need for the IRC to have direct unimpeded access to internal audit, investor lawsuits, client complaint summaries, external auditors and fund compliance officers. The qualifications for IRC members are not spelled out except that they must be independent. The recommendations or decisions of the IRC will not be binding upon the manager.

Certain time-proven investor protecting prohibitions will be removed. Examples of transactions that will no longer be prohibited are principal trading, lending money to related parties, buying securities of related parties and buying securities underwritten by an affiliated dealer while in primary distribution.

The Proposed Rule would also permit purchases and sales of securities between mutual funds in the same group. Under the Proposed Rule, certain changes to the fund mandate or its selection of auditor which currently require an investor vote in NI 81-102 [2] (referred to as fundamental changes) would now be referable to the IRC.

In addition to review by the IRC, inter-fund trades will be subject to specific enforceable conditions that address concerns relating to pricing and transparency in the capital markets.

The CSA suggests that the IRC should not have the power to terminate the management contract.

Proposed National Instrument 81-107 contemplates that the fund "must disclose in its prospectus and in its periodic continuous disclosure reports any instances where the manager did not follow a recommendation of the independent review committee, the general nature of the recommendation and the reasons for not following the recommendation."

B. Our Objections Regarding the IRC Proposals:

1. The non-elected committees will not have the power to overrule fund managers nor will managers be required to abide by the committees' decisions.

2. There is no explicit reference to the need for IRCs to have access to internal audits, investor lawsuits, client complaint summaries, external auditors and fund compliance officers.

3. Independence should not be the only qualifying requirement of IRC members.

4. The CSA unjustifiably believe that changes to a fund mandate or its selection of auditor involve business conflicts which can be satisfactorily reviewed by the IRC. Advance notice of such a change would replace the ability of an investor to vote, thus removing one of the very few mutual fund investor rights.

5. IRCs should have the power to remove a manager especially in the case of gross incompetence, a major breach of laws/regulations or outright fraud.

6. There is little historical evidence that savings from reduced compliance costs will be fully reflected in reduced investor charges. In addition, the savings come at the expense of added risks for fund investors, the costs for which have not been reflected in the cost-benefit analysis.

7. Disclosure is expected to take the place of statutory sanctions. In this the CSA is asking investors to rely on embarrassment instead of fund governance. Disclosing a conflicted decision does not necessarily establish that it is an appropriate one for the fund. Nor does such disclosure contribute to the reduction of fund fees or an increase in fund returns, which are primary interests of fund investors. Furthermore, the CSA proposals require investors to expressly request these disclosure materials or discover them for themselves on the Web. Canada can surely provide better investor protection.

8. Although the Proposed Rule would not regulate a broader mandate, the CSA hopes that fund managers will turn to their funds' IRCs for advice on a variety of matters beyond conflict of interest and will think creatively about how these groups can add value to their fund complexes. Hope is not an appropriate basis or a substitute for establishing the parameters of regulation. Also, given the history in fund governance in Canada we believe it is unlikely that IRCs will be given a broader mandate by fund companies. Furthermore, if the IRCs do their job right, they will have a full time job dealing with actual or potential conflicts of interest.

9. The CSA and the industry expect substantial cost savings, up to $1.5 billion over 10 years by implementing this principles-based framework. The calculation does not take into account the costs to investors of elimination of the prohibitions. Nor does the calculation take into account the costs to investors of bringing legal actions requiring an accounting (or other remedy) from fund managers.

C. Canadian Fund History and the U.S. Experience

Not uniquely, the Canadian mutual fund industry has had a checkered history involving cases of defective internal controls [3], major information security breakdowns, front-running, high closing, market-timing [4, 5], deceptive advertising, inadequate disclosure [6] and the infamous sales practices including Hawaiian junkets.

Mr. Eliot Spitzer and the SEC has exposed unsavory, abusive and illegal fund practices that the fund industry had for decades claimed did not exist. Market timing, illegal after-market trading and undisclosed incentive payments to brokers to promote certain funds have all been shown to increase fund company profits at the expense of investor returns. They also show how conflicted the industry is, even with the existence of boards of directors. A study [7] by Professor John Freeman of University of South Carolina demonstrated how the advisory conflict of interest raises fund fees for investors.

The U.S. fund scandals serve as a beacon for Canada. The chief outrage of the scandal is how easily managers put themselves ahead of investors. The revelations have conclusively proven that even IRCs with teeth are not by themselves sufficient to protect mutual fund investors. MFS, a subsidiary of Sun Life Financial (SLF) and the oldest mutual fund company in the U.S. is a case in point. Board members have been removed, brokerage cost disclosure will be expanded, fair value pricing has been introduced, and the independence of the board will be increased among a host of other governance tightening measures. Indeed, new MFS Chairman, Robert C. Pozen in testimony before the Senate Banking Committee asked for SEC reinstatement of at least one previous prohibition - soft dollar trading. [8] SLF's American fund investors will now have a far more robust governance regime than their Canadian unitholders. (See Appendix I)

The smaller Canadian economy with its higher financial service industry concentration, weak regulations, limited regulatory enforcement resources (13-19% in Canada vs. 29% for the U.S. Securities and Exchange Commission) and 13 provincial/territorial loosely coordinated securities regulators likely make the situation here more perilous for the average investor.

We assert that if Canadian regulators ignore or discount the U.S. experience and research, it is at the risk and peril of Canadians investors.

D. Background

Concept Proposal 81-402 *Striking a Framework for Regulating Mutual Funds and their Managers* [9] was published for comment on March 1, 2002. This concept paper proposed useful reforms to the current regulatory framework by improving mutual fund governance. Proposed changes included an IRC to minimize conflict of interest and a powerful board that would represent investor interests. SIPA commented on the previous version of this document as did numerous industry participants. It is noteworthy that not one of the investor protection initiatives we suggested is included in NI 81-107.

The narrowed role for the governance regime in NI 81-107 fundamentally changes the previously proposed relationship between the IRC and the fund manager so that the IRC is not overseeing the manager's actions as contemplated in the Concept Proposal. Under the current proposal, where there is a conflict of interest as assessed by the manager, the fund manager must refer the matter to the IRC and obtain its recommendation. The manager would be allowed to proceed even where the governance agency does not agree, but must disclose the governance agency's position and the reason for not following its recommendations to the fund's unitholders. Disclosure is a necessary but insufficient condition for robust investor protection.

NI 81-107 is not in the public interest and we recommend it be replaced with fund governance as contemplated in the Stromberg report(s) [10, 11] and other studies.

E. The Issues IRCs Will Have to Address

The IRC will have to deal with the following thorny issues without the regulatory backbone of prohibitions:

- management fees;
- soft dollar trading (such trading involves the fund paying higher expenses than normal in exchange for "free" research and other undisclosed and possibly abusive benefits) [12,13];
- the allocation of sales, commission and distribution costs to the fund;
- the non-allocation on DSC early redemption revenue to the fund;
- the use of incentive fees paid to brokers and dealers to promote select sponsor funds;
- the purchase of IPO stocks, income trusts or bonds from a related party;
- the purchase of shares of the parent company or affiliated companies;
- the selection by the fund to exclusively utilize related party organizations as custodians or brokers without competition or price negotiation;
- Insider trading of fund units;

- Proxy share voting and disclosure;
- Fund mergers and termination;
- Inaction resulting from a conflicted position not voting.

It is not hard to imagine an IRC member having an affiliation with a company whose shares are owned by the mutual fund. A conflict could arise between the best interests of the fund and the interests of the member's corporate affiliate.

And what will the IRC do if a portfolio manager is rewarded in stock options related to the fund sponsor, as is the prevailing practice today? Will that situation be considered a conflict of interest? How will it be determined if a merger of two funds is in the best interests of the unitholder? Will the committee be allowed to waive deferred sales charges when such mergers occur, or when the portfolio manager is unilaterally changed, or voluntarily resigns or the fund is unilaterally terminated? When a fund is closed, the fund is not incurring sales, marketing or sales commission costs, but will the MER remain the same?

The inherent flaw in the committee process is very clear. The toothless IRC will simply not be able to thwart these issues and may not even be aware of them (unless investigative resources are made available to the committee). In addition, the costs of keeping the manager honest will be borne by the funds. The criterion does not include a statement that decisions must be in the fund's *best* interests. NI 81-107 is an illusion of investor protection and is, in fact, de-facto deregulation. Appendix II illustrates the great difficulty of dealing with conflicts of interest in isolation and in the absence of a regulatory framework.

F. Some Questions Worth Asking and Answering

How will a committee member argue that a "hot" IPO should not be purchased from an affiliated company especially if competitor funds have no corresponding constraints? Is it reasonable to assume that a portfolio manager who consistently underperforms the benchmark or peers would be removed or have the fees reduced if the portfolio manager is in fact the sponsor of the fund? This is in fact one of the greatest conflicts. If an advisor or sub-advisor is convicted of securities law violations, will the IRC really be able to move the fund to another advisor?

How will a fairness opinion be obtained when proxy shares are voted if the sponsor or a related party has or is seeking a business relationship with a corporation say for a lucrative pension fund management contract, investment banking opportunity or banking relationship?

How will serious market-timing issues be addressed? Even the current prospectus disclosure can be considered a potential conflict as in most cases a rapid trading fee may or may not be imposed strictly at the fund companies' sole discretion.

In the case of a bank-owned fund, will there be a requirement to disclose the precise method for dealing with foreign exchange to ensure that the international or global fund receives a fair deal? (Are currencies converted in bulk across funds in the complex? At what rate? Is there a commission charge levied?). Will IRC's be allowed to probe this type of accounting conflict of interest issue? Will it even be considered a conflict of interest situation? "Inefficiency", intended or not, can camouflage conflicts of interest.

A recent case [14] alleged that TD Waterhouse traded securities without proper disclosure to its clients and was earning revenue from the conversion of currency for securities trades. The class action certified case approved a national settlement that involved settlement trading vouchers that allowed a credit for a number of trades depending on the amount of client conversion activity between May 1994 and November 2001. This lack of disclosure is also an issue with global and international mutual funds where the portfolio is comprised of securities denominated in foreign currencies. Mutual fund annual reports do not disclose to unitholders the details of how currency conversion is treated nor if there are fees or commissions charged to the fund. Since any such fee is a cost to the fund it should be fully disclosed as it represents a conflict of interest.

It is simply not reasonable or even realistic to believe that part-time committee members without authority and with diluted regulations will be able to protect investors from abusive self-dealing. We haven't even discussed performance based compensation or the disclosure of fund holdings or insider trading in fund units by management and IRC members.

There are many more issues besides conflict of interest that adversely impact investors. Front running, for example, can and has hurt investors by creating an artificial demand for a stock purchased by fund employees at a lower price. Abusive sales practices, sales contests, biased compensation grids and embedded/masked commissions are other examples.

As for disclosure, fund financial statements, annual reports and prospectuses have a long way to go before they can be considered useful and safety-enhancing. Where will the question of excessive MERs be resolved? What mechanisms will be in place to prevent and detect closet indexing which causes investors to pay for professional management but achieve index-like performance? Is excessive portfolio trading a conflict of interest if it rewards affiliated brokers high commissions (and penalizes the fund with high trading expenses) or is it merely a portfolio manager's right?

To whom will external auditors and compliance officers' report? Auditors are especially well positioned to provide guidance on weak internal controls and systems and spot problems. Under no conditions should the fundamental right of investors to vote on a change of auditor be removed. Will the fund be permitted to employ the same auditor as the fund sponsor or parent? Hopefully not but no regulatory guidance is provided. What will be the accountabilities of trustees of the mutual fund trust? Will following the decisions of the IRC protect the fund company/trustees from civil and criminal legal action?

Will IRC's be accountable to investors to ensure that securities law (and other laws) and prospectus declarations are being complied with? Will they be required to be investors in the fund? Will the IRC be accountable to ensure that systems are in place to protect the privacy and security of unitholder personal information and the information is not used for unintended and undisclosed purposes? NI 81-107 suggests that they will not.

Would the annual report contain a section dedicated to investor protection and will the IRC Chair be required to sign off that investor abuses due to conflicts have not occurred?

Will the IRC have a budget to use third party experts to investigate or analyze real or suspected situations?

Will investors be permitted to have direct contact with IRC committee members (assuming contact information will be provided)? Will customer complaint summaries be made available to the IRC? Such complaints are an invaluable source of customer dissatisfaction and potential abuses.

What legal or other actions will a fund realistically be able to take if a parent or related party has unduly caused undue losses for the fund? This could happen say if a "hot" IPO is purchased from a related brokerage and it is subsequently discovered that the prospectus contained a material misrepresentation. Would inaction be considered a conflict of interest?

And perhaps most importantly, if committee members do uncover costly wrongdoings due to a conflict of interest how will the offenders be punished and investors compensated for the losses? Will a system of arbitration be established to deal with cases of alleged investor exploitation? Will the IRC be permitted to meet separately with regulators or law enforcement in the event of serious malfeasance?

Conversely, if the IRC approach proves to be an outright failure what would happen next? NI 81-107, if it is to be enacted at all, must more clearly resolve the questions raised here. As it stands, IRCs will have no material impact on preventing investor abuse or on achieving investor protection and fees may rise to cover the cost of the IRC.

G. Response to Specific Questions

The following is our view on specific questions raised in the request for comment. Again, we emphasize our comments do not condone the new approach to governance which we believe is fundamentally flawed.

1. Do you think this Instrument should apply either more broadly or more narrowly? If so, please explain why and in what matter.

As per our previous submission, we believe the mandate must apply more broadly since the boundaries of conflict of interest are not always sharply defined and the threats to investors go well beyond conflicts of interest. Nothing short of a board with real authority to implement change can be assumed to provide any level of protection. This would have to be supported with tough regulations and robust, timely regulatory surveillance and no-nonsense enforcement.

2. Do you agree with a 'principles' based definition of independence? Are there alternatives?

The problem with principles based rules is their enforceability and the great variability that will occur between fund manufacturers over time. A combination of specific rules and principles should be effective.

3. Do you consider the definition of independence in subsections 2.4(2) and (3) appropriate?

Independence criteria appear adequate. Other important matters include committee member qualifications, their degree of ownership of fund units and their experience in representing investor interests. We would clarify the requirement to include a restriction on an IRC member if he/she has provided consulting services or has been an employee of the

fund or related parties in the past 24 months. IRC members must receive no benefit from the funds or fund company apart from their stated fee.

4. *Commentary 4 describes certain categories of persons we consider to have a material relationship with the manager or the mutual fund. Do you agree with the categories of precluded persons? Are there other categories that should be added?*

The list of precluded persons should be extended to include members of affiliated companies, the parent company, personal friends of fund company executives and former Commission staff. Additionally, there needs to be a mix of different skills represented so that individuals should be excluded if they represent a skill set that is over weighted in the committee. A selection team should initially select members based on predefined criteria that focus on investor protection.

5. *Is the 'cooling off' period in Commentary 4 an appropriate period? Too long? Too short?*

We believe the 3-year cooling off period is adequate.

6. *We were told that without a limit on the liability of members of the independent review committee, insurance coverage for the members would be difficult to obtain. What are your views, given the responsibilities the IRC will have under this Instrument?*

Since the IRC will only recommend, suggest or advise, there need not be any D & O insurance issues.

Will potential members be deterred from sitting on the independent review committee without such a limitation? We believe a legal opinion on the matter is required before the question can be answered. Presumably fund trustees already have such limitations or D & O and E & O insurance.

7. *We believe the changes to a mutual fund set out in section 3.3 involve conflicts of interest which can appropriately be referred to the independent review committee. Is this the right approach? Are there alternatives?*

We believe the correct reference here is section 3.2. The list of changes appears relatively complete. Other changes, apart from conflicts of interest can impact performance; e.g., changes in currency hedging policy, a change involving a merger between funds. These should also be referred to the IRC.

8. *Does the right to transfer free of charge to another mutual fund managed by the same manager need to be mandated or is it industry practice?*

It depends on the company. However as noted above the transfer should not be limited to funds offered by the fund company. If a fund has changed its character from the original basis for the investment, unitholders should be able to exit without charge.

Furthermore, investors should be totally and unconditionally free of any account closing, transfer to a third party, switch or early redemption fees if the manager of the fund is changed or the fund is embroiled in any major securities law breaches.

9. *Do you agree with our proposals for inter-fund trading (in particular, the scope of the provisions?) If not, please explain.*

Inter–fund trading is a complex issue. The commentary in para 3.3 (3) should not be left as an expectation – it should be codified in law.

10. *Should clause 3.3(1) (b) (1) refer to "the last sale price" or should it enable managers to trade within the bid/offer spread during the trading day?*

Since mutual fund investments are supposedly long term (despite the fact that the average hold period us less than 12 months), the details are not critical. The real issues are the unnecessarily high portfolio turnover rates that trigger tax liabilities for investors and incur high trading costs that reduce returns.

11. *Is the pricing referred to in paragraph 3.3(1) (b) appropriate for illiquid exchange-traded and foreign exchange-traded securities, over-the-counter equity securities and debt securities?*

No comment.

12. *Should the current market price of illiquid equity securities on an exchange be treated differently from over-the-counter equity securities?*

The biggest issue with illiquid securities is the opportunity to exploit stale pricing. We assume a fund will be required to have rules limiting the fraction of illiquid securities that can be held and to disclose this in the prospectus.

H. Unintended Consequences of NI 81-107

Market Distortions

NI 81-107 would remove many of the self-dealing prohibitions that will lead to more conflicts of interest and disadvantages for unitholders. But perhaps a more perilous aspect of the elimination of these prohibitions is the impact on Canadian capital markets. The fund industry is now so large it is the market. Should bank and insurance mergers take place, the concentration of share ownership in Canada will be in the hands of a very few institutions. Removal of the prohibitions will add serious market distortions that will further harm the investing public. Say CIBC World Markets is floating a new issue of a bond, stock or income trust. Under NI 81-102 Section 4.1(l), CIBC mutual funds have to wait 60 days before being able to invest. With the new rules in place, investors might be hurt in several ways:

- the availability of a ready market for an IPO may cause a decision to price the IPO higher than would otherwise be the case;
- the availability of a ready market for an IPO can be used to fill a gap in an undersubscribed IPO, earning fees for investment bankers but adversely impacting mutual fund investors;

- it encourages further erosion of the mythical "ethical walls" between mutual funds and their broker affiliates - these are the same type of walls that supposedly existed between analysts and investment bankers that caused Nortel, Corel, YBM Magnex, Livent and Bre-X and a host of other stock disasters to take place;

- the affiliated mutual fund can be used to artificially prop up a weak IPO share price to prevent it from tanking too shortly after distribution;

- sometimes waiting 60 days allows the markets to establish a more rational price for a security; buying early may prove expensive for the fund as IPOs typically are priced at the highest possible market price that will sell;

- conversely, "hot" IPOs can be used to artificially boost short-term fund returns to increase sales; retail investors always chase returns. The resulting sales would create artificial market activity;

- if it turns out that the IPO was based on material misrepresentations, under the proposed rules it is highly unlikely the affiliated fund would participate in litigation or class actions to recover losses from the related dealer on behalf of unitholders;

- all the trading activity with affiliated brokers will artificially boost earnings of the parent bank and increase its share price.

Proxy Voting Concerns

A rule that prohibited funds from owning parent company shares within their funds has now been circumvented by exemptions to that rule. This could lead to conflict issues. The fund may vote its shares consistent with the parent's wishes in support of an anti-takeover bid, or to prop up its own share price. The watering down of self-dealing restrictions could permit a fund to unduly vote its large block of shares to support a position that the investment banking arm is supporting and thereby impacting market pricing. No doubt a large spectrum of possible market distortions will be opened up as billions of dollars become available by multi-billion dollar funds governed only by foggy principles, a weak IRC and large for-profit financial institutions.

Diminished Opportunities for Investors to Seek Redress

Another major consequence of the proposed governance regime is a diminished opportunity for investors to seek redress. Aggrieved individuals cannot seek redress based on explicit breaches of statutory prohibitions on self-dealing and other related party transactions involving conflict of interest. Legal action on this basis is much more straightforward and less costly than a civil remedy relying upon common law principles. The new system makes it extremely difficult for investors to file claims of abuse justifying restitution because of prohibitive legal fees.

I. Minimum Investor Protection

Instead of NI 81-107 the following minimum investor protections should be provided by the CSA:

- improved annual reports including a MD & A, greater breakdown of costs; e.g., distribution costs, governance costs, unit brokerage expenses and a section on governance including comments from the IRC;
- reinstitution of mandatory transmission of annual reports to investors and the introduction of quarterly reports;
- the provision of a mutual fund investor protection fund;
- the provision of a capital requirement for potential liability claims
- the ready availability for purchase in Canada of U.S.-based mutual funds covered by SEC regulations;
- the mandatory inclusion in prospectus disclosures entitled "Governance Risk". This is the risk associated with weak or inadequate fund governance;
- an increase of industry sponsored arbitration limits from $100,000 to $350,000
- a public statement that all CSA members will incorporate Investor Advisory boards into their structures along the lines of those in the UK and Australia;
- the regulatory requirement for fund companies to publish their Code of Proper Business Conduct and make it available to the public upon request;
- the regulatory requirement for fund companies to prohibit frequent trading which could be defined as a 90 day hold period (except for cases of personal financial emergency and the basic rights of withdrawal/rescission);
- the regulatory requirement for fund companies to establish written ethics policies and programs that would include personnel training, annual certifications and hotlines;
- the passing of whistleblower laws that would protect truthtellers (many tips on conflicted practices have come from fund employees);
- the requirement that independent auditors be chartered to pass opinion on internal controls. The fund auditors should not be the same as the fund company auditors or its parent since the end clients are different in each case. Furthermore, since the mutual fund pays the audit fees, unitholders are in fact the client not the fund company;
- the requirement that any investigation, special audit, forensic or analytic resources necessary to protect investors against conflicts of interest be chargeable to the fund management company and that this cost not be an allowable cost to be subsumed in the management fee allocations;

- the requirement that fund companies publicly disclose their proxy share voting policies, the actual votes they cast and the supporting rationale for their position. This is already a requirement for U.S. mutual funds;

- physical, functional and organizational isolation between fund executives and personnel and affiliated broker personnel;

- financial statements to flag any holdings acquired under a conflict of interest by either the fund sponsor or its affiliates.

ADD the following prohibitions:

- limit soft dollar transactions to those that clearly benefit fund investors and require proper itemized accounting evidencing the benefit

- ban allocating shelf-space expenses to a fund or require their disclosure;

- ban allocating any marketing or other payouts to dealers, advisors or distributors to a fund or include quantitative disclosure;

- ban hedge funds from purchasing mutual funds;

- ban shorting as an investment strategy for a mutual fund;

- ban the diversion of early redemption fees to the fund sponsor instead of the fund which incurred the original cost;

- prohibit fund companies from marketing governance boards as an investor protection advantage of investing in mutual funds.

We note that a committee of IFIC is looking at recommending to the CSA the automatic application of a mandatory two percent penalty fee "or more" on sales made within five days of purchase of any mutual fund, except money market investments.

Conclusion

NI 81-107 provides for removing prohibitions contained in securities laws on self-dealing and other related party transactions involving conflicts of interest and replaces them with toothless IRCs. Examples of transactions that will no longer be prohibited are principal trading, lending money to related parties, buying securities of related parties and buying securities underwritten by an affiliated dealer while in primary distribution.

NI 81-107 may be substantially increasing the non-market risks of investing money with mutual fund managers.

In summary, our main reasons for rejecting NI 81-107's approach are:

1. There is no evidence provided that the approach will work in investors' best interests. Hard rules are replaced by non-binding discretionary decisions of non-elected officials who may or may not be investors in the fund and certain current and important investor voting rights such as a change of auditor are lost;

2. Previous studies, including the Stromberg report(s) and the *Five Year Review of the Ontario Securities Act* [15], that recommended more robust investor protecting structures have been unduly discounted to satisfy industry participants not investor protection;

3. Canadian mutual fund investors will have significantly less protection than their U.S. NAFTA partner counterparts. Recent SEC regulatory changes have dealt with board composition, stiffer penalties, auditor independence, proxy voting, improved disclosure and a host of other pro-investor safeguards;

4. The unnecessary elimination of self-dealing prohibitions will not only threaten mutual fund investors but because of their sheer size, the industry could adversely affect and distort Canadian capital markets to the detriment of Canada and all its citizens;

5. The proposed language makes extensive use of hopes, expectations and aspirations that are wholly unsupported by the historical behavior of the industry. Too many fund companies regard salespersons and distributors as the customer not the trusting investors who provide their hard earned money to the fund. Not a single fund company has adopted Total Quality Management, Six Sigma or ISO 9000 management systems that emphasize customer focus, quality control, ethics and continuous improvement;

6. The fragmented and piece-meal approach to mutual fund regulation is dysfunctional. SIPA recommends that all CSA initiatives be coordinated, time phased and integrated into a holistic approach with full investor participation;

7. The system puts too much unrivaled and loosely regulated financial power in the hands of too few people. Bank and insurance company mergers will only amplify the degree of potential abuse to Canadian citizens;

8. NI 81-107 removes many of the existing rules that have made mutual funds a relatively straightforward and safe investment for a lot of small investors and replaces it with weak governance and a minefield of potential issues, complexities and risks.

9. The elimination of certain investment restrictions designed to ensure a mutual fund's ability to meet redemptions on demand, a key fund attribute, unnecessarily adds to redemption risk. Mutual funds, not unlike demand deposits at banks, are redeemable on demand or within a very short period after demand. This means that mutual funds need safety and robustness rules comparable with those that govern financial institutions that are CDIC members. Mutual funds are not bound by liquidity constraints or required to carry E & O insurance. This suggests that mutual funds need oversight at least comparable with the oversight to which deposit-taking financial institutions are subject.

10. The role of statutory regulators whose mandate is to protect citizens is greatly diminished while a set of "mini-SROs" run by industry participants is created that have not earned our trust;

11. Aggrieved investors have a diminished opportunity to file claims of abuse and requests for restitution;

12. The proposed IRC will not have any power to stop conflict of interest abuses and if history is any guide, there may be limited regulatory enforcement of the requirement for the mutual fund management company to disclose differences of opinion between it and the independent committee. Additionally, penalties have been relatively light when imposed, despite the fact that fund abuse cases can involve tens of millions of dollars. Most importantly, there will be no law on which to base a regulatory administrative action even if the regulatory authority felt inclined to intervene in egregious situations.

We note that Section 2.3 provides a transition period of one year from the coming into force of the Instrument (to give managers time to set up independent review committees for their mutual funds). This means that, assuming a 3 or 4 month CSA review from April 9, and a one year transition time, the new rules would only come into force in August 2005; a full decade after the need for dramatically improved fund governance was articulated by Ms. Stromberg.

A weak governance structure is not in the best long-term interests of the mutual fund industry. Stricter fund governance rules will benefit, in the long run, our capital markets in making them safer and more transparent. Otherwise, other competitive better-regulated products will steal market share possibly to foreign issuers. In fact, after all the reforms, U.S. based mutual funds will be cheaper and better governed than their Canadian counterparts. [16] We believe explicit and clear regulations, properly enforced; protecting investors is in the best interests of Canada.

Independent of the final shape of fund governance in Canada, we strongly recommend that Canadian investors be permitted to purchase U.S. based mutual funds. They are closely regulated, are far cheaper, provide a wider selection of investment options, and have more robust governance regimes. This would also create a positive incentive for the Canadian fund industry to:

- Lower fees
- Improve customer service
- Increase productivity
- Install meaningful governance processes and boards

In the end a better and stronger Canadian fund industry would result.

We appreciate the opportunity to comment on this important proposal. If we can provide any other information or if you would like to discuss any of the issues raised in this letter, please contact SIPA.

Yours very truly,

Small Investor Protection Association

Ken Kivenko P. Eng.	Robert Kyle	Stan Buell
Chair, Advisory Committee	Executive Director	President
416-244-5803	416-925-6230	905-471-2911

Appendix I MFS Remedial Action

MFS Investment Management, a U.S. mutual fund subsidiary of Canada's Sun Life Financial Inc., pleaded with the Senate Banking Committee for the reinstatement of severe restrictions by the U.S. Securities and Exchange Commission (SEC). Following a payment of $225 million in February 2004 to the SEC to settle improper trading charges, MFS made a number of significant changes to fund governance. These steps included:

- strict exchange limits;
- increased monitoring of trading in the funds in an effort to reject/deter trades that would be harmful to other shareholders;
- fair value pricing;
- a 2% fee in MFS international funds for redemptions made within 30 days of purchase.

MFS has also taken additional steps to:

- retain an Independent Compliance Consultant to conduct a comprehensive review of MFS' supervisory, compliance and other policies and procedures designed to prevent and detect conflicts of interest, breaches of fiduciary duty, breaches of the Code of Ethics and federal securities law violations by MFS and its employees. In accordance with guidelines in the agreement, MFS will adopt the recommendations of the Consultant. Commencing in 2006, and at least once every other year thereafter, MFS will undergo a compliance review by a third party;
- prohibit soft dollars transactions because of the conflicts of interest and higher costs for investors;
- further ensure the independence of its board, which is already 75% independent, including its chair, by instituting independent counsel for both the independent trustees and MFS funds;
- require the independent trustees to appoint an independent compliance officer who will be responsible for assisting the board and all of its committees in monitoring compliance by MFS Funds;
- increase disclosure of portfolio turnover and brokerage costs and expand disclosure of volume sales discounts, known in the industry as "breakpoints," and cash payments by MFS to brokers;
- create an Internal Compliance Controls Committee that will report regularly to the Chief Compliance Officer. This officer will also report to the independent trustees of the MFS funds any breach of fiduciary duty or federal securities laws;
- establish a Code of Ethics Oversight Committee, consisting of senior executives of the firm, with responsibility for all matters relating to issues arising under the MFS Code of Ethics;
- hire a corporate ombudsman to whom MFS employees may convey concerns about business matters they believe implicate matters of ethics or questionable practices.

A lot can be learned from the conflicts of interest encountered and how U.S. fund companies, including those owned by Canadian fund sponsors are dealing with the issues.

Appendix II NI 81-107 Conflict Resolution Scenarios

The scenarios described below are realistic. They show the arguments for a conflicted decision are alluring, while the ability to provide solid counterarguments is not as easy as one might believe. There is a fine line between sharp business practices and a breach of fiduciary duties. The difficulties that would be faced by powerless IRC's without the underpinning of securities laws would be insurmountable. In any event, disclosure of conflicted decisions alone is not an effective investor protection. Most mutual fund investors do not have the skills, tools experience or inclination to assess disclosed information especially when it is expressed in legalese. Indeed, this is why they invest in mutual funds. There must be a body of enforceable (and enforced) laws that would provide the basis for the disgorgement of ill - gotten gains while at the same time permitting criminal and civil charges to be laid against those who breach their fiduciary duties to fund investors.

Scenario No. 1 Conflicted IPO

FUND SPONSOR: Larry, have I got a deal for you.

IRC: OK Martha, tell me about it.

FUND SPONSOR: Our brokerage affiliate has a "hot" income trust IPO we'd like to buy for the fund. There is a conflict but this trust is good quality and we'd miss out on some fine returns. Besides our competitors have no restrictions, so all we're doing is leveling the playing field. Remember too, under the old system we routinely got OSC exemption orders for this sort of thing so it must be OK.

IRC: Sounds logical to me-go ahead.

Scenario No. 2 Voting Right/Choice of Auditor

FUND SPONSOR: We're about to change our external auditor. Our parent corporation is switching and we can get economies of scale.

IRC: But shouldn't the auditor of the fund be independent from the parent? After all, it is the fund investors that need reassurance not the common stock investors of your parent.

FUND SPONSOR: There's no regulatory requirement for auditor independence, the fund will save money and besides the auditors haven't reported any issues in the last decade.

IRC: I'm still not convinced

FUND SPONSOR: So noted. We'll report your comments but will proceed with the change of auditor.

Scenario No. 3 **Allocation of Proceeds**

IRC: Can you tell me why DSC early redemption fees aren't credited to the fund? Why do they go to the fund sponsor? It's the fund which originally financed the five percent sales commission paid to the dealer.

FUND SPONSOR: No, that's not right. We write the cheque to the dealer so if there is an early redemption we want our money back. The OSC has always accepted this.

IRC: Yeah, but the management fees charged to the fund covers these expenses so they should have the money returned if there's an early redemption.

FUND SPONSOR: We don't agree, but in any event, this isn't really a conflict of interest issue. We don't plan to report it as such. Please don't raise it again.

Scenario No. 4 **Conflicted Proxy Share Voting**

IRC: Why are you voting shares for management? This is a mismanaged company that has abused shareholders for years.

FUND SPONSOR: The management has committed to improve corporate governance and replace their VP of sales. We own a lot of stock in this company and if we unseat the current board the stock price will fall, actually hurting our fund in the short-term. Besides, we're trying to get their pension business which means we can allocate less overhead cost to the fund in the future.

IRC: I see your point.

Scenario No. 5 **Conflicted Supplier Selection**

FUND SPONSOR: We want to renew our annual contract with our custodian, an affiliated company. Their fees are competitive and we're very happy with the services provided.

IRC: How do I know they're competitive? Have we asked for bids? Have we negotiated prices? Have we included robust performance and quality criteria in the subcontract?

FUND SPONSOR: Gimme a break. We're talking a custodian here. Our information systems are linked with the affiliate. Any transition to another supplier would be costly and disruptive. Custodial expenses are not a big cost item anyway.

IRC: That's a convincing argument-approved.

FUND SPONSOR: The preliminary financials are in and we had a great year in increased fees. We're going to give all of you an increase and 25,000 options for our common stock.

Scenario No.6 **Conflicted Level of Trading**

IRC: I'd like to speak to you regarding the excessive portfolio turnover in our equity funds. With a near 200% portfolio turnover ratio were incurring high brokerage commissions and tax liabilities for our investors. Much of the commissions are going to a related company.

FUND SPONSOR: You know, this has nothing to do with your mandate. Also, we're trying to maximize pre-tax returns not after-tax returns.

IRC: Maybe. We advertise that our funds are long-term investments and we barely hold our stocks for six months. The marketing materials hail buy and hold and that's exactly what the portfolio managers aren't doing.

FUND SPONSOR: Our portfolio managers need to trade as they see appropriate. It's nothing to do with a conflict of interest. Sure, our sister businesses get some hefty commissions but more than half of our brokerage transactions are not with related parties. Plus, we always disclose related party payments in the annual report. I should add that we use soft dollars to acquire first-rate research. We get it a lot cheaper than if we paid for it directly.

IRC: Don't soft dollars distort accounting, cost the fund more and lead to significant potential for abuse?

FUND SPONSOR: Like I said before this is not a conflict of interest issue. The IRC shouldn't try to second guess our investment professionals. If we have any issues, they are regulatory and financial. We're in full compliance with securities laws and our auditors don't have any issues with our actions. In any event, if any investors don't like the way we run the fund they can always redeem their units and invest their money elsewhere.

IRC: If it's OK with the CSA and our auditors, I'm comfortable. I agree that it's not really a conflict of interest issue and so no reporting to investors is required.

As can be seen, conflict of interest resolution can be successfully debated and reconciled. After a period of time, a number of standard practices become acceptable and part of entrenched policy based on precedent. They would not be raised again with the IRC in the future. Over time, very little in the way of conflict of interest would exist in the minds of the fund factories and the independent review committees. The inevitable result would be reduced returns for investors.

> However, "the question that needs to be answered, on behalf of all investors, is this: Were all policies and procedures fully and fairly followed?"
>
> David Brown – Chair, Ontario Securities Commission[17]

Footnotes

Hyperlinks
(http://regulators.itgo.com/SIPA/NI_81-107/Submission.htm)

[1]"Request for Comment, Proposed National Instrument 81-107, Independent Review Committee for Mutual Funds, Prepared by the Canadian Securities Administrators, (2004) 27 OSCB 465-525

[2] National Instrument 81-102, Mutual Funds Amendment Instrument, (2004) 27 OSCB 745-751

[3] 2003 Annual Report, Compliance Team, Capital Markets Branch, OSC, (this report revealed a large number of control and compliance issues within the mutual funds industry), (2003) 26 OSCB 5236

[4] "Transamerica Life plans to compensate 12,000", The Toronto Star, 09 September 2000

[5] "OSC chief says market timing may be occurring", Globe and Mail, 06 April 2004

[6] Levitt, Arthur, "Take on the Street: What Wall Street and Corporate America don't want you to know", Pantheon Books, ISBN 0-375-42178-5, 2002. Mr. Levitt is former Chairman of the SEC and noted for his pro-investor inclination .The book provides useful ideas on fighting back and illustrates how politics and lobbying shape securities legislation.

[7] Freeman J. & Brown S. L., "Mutual Fund Advisory Fees: The Cost of Conflicts of Interest", University of Iowa Journal of Corporation Law, (Spring 2001)

[8] "MFS takes steps to boost mutual fund transparency", Reuters, 16 March 2004, See Appendix II

[9] OSC/CSA, Concept Proposal 81-402, Striking A Framework for Regulating Mutual Fund and their Managers, 01 March 2002

[10] Stromberg, Glorianne, "Investment Funds in Canada and Consumer Protection: Strategies for the Millennium". This Report dated October 1998 was prepared for the Office of Consumer Affairs, Industry Canada (ISBN-0-662-27425-3/code 52487E). It examined the requirements for the reasonable protection of investors and made recommendations to enhance investor protection.

[11] Stromberg G., "Regulatory Strategies for the Mid '90s ", January 1995 (this important study on the investment fund industry in Canada which was prepared for the Canadian Securities Administrators has been virtually ignored in the formulation of NI 81-107.

[12] "You only pay twice", Globe and Mail, 29 December 2003

[13] "Outcry over 'soft dollars' sparks new hard line", Globe and Mail, 05 April 2004

[14] "Foreign Exchange Class Action", Branch MacMaster's Class Actions, 17 September 2002

[15] "Five Year Committee Draft Report: Reviewing the Securities Act (Ontario)", Crawford, Purdy (Chair), 29 May 2002

[16] Harmes, Adam, "Unseen Power: How Mutual Funds Threaten the Political and Economic Wealth of Nations", Stoddart, 2002 (ISBN-0-773-73283-7)

[17] "OSC funds probe moves to last stage", Canadian Press, 06 April 2004