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To: Canadian Securities Administrators

c/o John Stevenson, Secretary, Ontario Securities Commission

and Denise Brosseau, Secretary, Commission des valeurs mobilières du Québec

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Dear Sirs:

This letter is in response to your request for comments on Proposed National Instrument 81-107 (Independent Review Committee for Mutual Funds) published in the Ontario Securities Commission Bulletin on January 9, 2004 at (2004) 27 OSCB 526 (the “Fund Governance Proposals” or the “Proposals”). The following are the comments of Fidelity Investments Canada Limited (“Fidelity”).

Who is Fidelity?

Fidelity is one of the largest managers of mutual funds in Canada, with more than $30 billion under management in Canada. We are part of a group of companies known as Fidelity Investments, the head office of which is located in Boston, Massachusetts.

Fidelity Investments is an international provider of financial services and investment resources that help individuals and institutions meet their financial objectives. The Fidelity Investments group manages a total of more than US$850 billion in more than 300 mutual fund portfolios and other institutional accounts around the world.

Fidelity Investments has been in business for more than 50 years and has grown to become one of the largest mutual fund companies in the world with more than 19 million investors around the world.

The Role of Governance

The Canadian mutual fund industry is currently under more intense scrutiny and subject to more criticism than at any time in the past thirty years. Commentators have expressed concerns about the structure of the industry, the way that mutual funds are regulated, and whether investors are being treated fairly. In the U.S., the intensity of the criticism and concerns is even greater. In this volatile environment, there is great pressure on regulators to take action, to do something, to introduce new regulation with a view to solving the purported problems. We do not believe that legislation introduced in response to a perception of crisis is likely to serve the long-term interests of the Canadian mutual fund industry and its millions of investors. We applaud the Canadian Securities Administrators (“CSA”) for the measured way in which they have so far reacted to recent events, and we encourage the CSA to maintain that long-term perspective in connection with issues of fund governance.

Whatever the value of fund governance, it is clear that it is not a panacea. It is important to recognize that not all issues involving mutual funds are issues of governance. The legislative framework that governs U.S. mutual funds has more elaborate governance requirements than any other jurisdiction in the world, yet it does not appear that the American fund governance regime has eliminated or even reduced the number of problems in that industry. There appears to be very little evidence, either from the U.S. experience or otherwise, to suggest that fund governance is the appropriate regulatory response to many of the issues currently under examination in the Canadian mutual fund industry. Accordingly, we submit that it is critical that the CSA consider very carefully whether the purported benefits of the Fund Governance Proposals are likely to outweigh their costs over the long term.

Costs vs. Benefits

It is a fundamental principle of regulation that the benefits associated with any initiative should outweigh its costs. We believe that this basic cost-benefit analysis ("CBA") ought to be applied with respect to both the overall impact of an initiative as well as the impact of individual elements of a proposal. In developing and assessing new rules, the CSA generally show a disciplined attention to the importance of a CBA which we support and commend.

We believe it is important that the Fund Governance Proposals be subjected to a rigorous, high-quality CBA before being finalized and implemented. Although the Office of the Chief Economist of the Ontario Securities Commission has provided a proposed methodology for a CBA, there is still much work to be done before a satisfactorily robust CBA is ready for public examination. We regard this work as a critical prerequisite to any new fund governance regime.

Inter-Fund Trading

In our view the principle that the Fund Governance Proposals, in general, ought to be required to satisfy a strict CBA also translates to specific elements of the Proposals. If particular aspects of the Proposals entail costs greater than the benefits they produce, then we would suggest that such elements should be reconsidered.

We are particularly concerned about the inter-fund trading regime set out in s. 3.3 of the Proposals. Fidelity is a strong advocate of inter-fund trading, which we believe offers meaningful and tangible benefits to investors. Fidelity has extensive experience with inter-fund trading in the U.S. and other jurisdictions around the world. In Canada, we have been seeking the exemptive relief necessary to do inter-fund trading for more than a decade. Consequently, we are pleased to see that inter-fund trading is part of the Proposals, but we are concerned that the regime contemplated imposes unnecessary costs that will deny investors some of the benefits that they would otherwise enjoy.

Section 3.3 generally copies the framework established under U.S. legislation. We commend the CSA on this approach. The American rules for inter-fund trading are well-established and have been proven to operate successfully. We believe there is merit in consistency, especially when one can follow a well-tested model. Moreover, by ensuring that the Canadian and U.S. regimes are as similar as possible, the CSA will enable firms that manage funds in both markets, like Fidelity, to maximize the opportunities for inter-fund trades and thereby ensure the greatest savings to investors. If, however, there is any material divergence in the regulatory regimes, then it is more likely that Canadian mutual funds will effectively be disqualified from participating in inter-fund trades with non-Canadian funds due to the incompatible requirements.

The only significant discrepancy between the existing U.S. inter-fund rules and those set out in the Canadian Proposals arises in subsection (c) of section 3.3(1), which imposes a requirement that trades be "printed". This printing requirement represents a real cost to investors that does not appear to have a corresponding benefit. Indeed, the printing obligation will not only impose a financial cost but is likely to deny Canadian mutual fund investors the benefit of savings that they might otherwise enjoy when their funds are unable to complete inter-fund trades with U.S. regulated funds as a result of this inconsistency in the regulatory regimes. We note that not only is there no similar printing requirement under U.S. law, but U.S. mutual funds are in fact prohibited from paying a commission on inter-fund trades. Consequently, if there is any financial cost associated with the printing requirement, then either Canadian funds will need to bear the full amount, or U.S. mutual funds would be barred from engaging in inter-fund trading opportunities with Canadian mutual funds. We do not believe either outcome is in the best interests of Canadian mutual fund investors.

We would encourage the CSA to carefully re-evaluate the printing requirement, as it is not clear to us that it serves any legitimate regulatory objective. We submit that printing inter-fund trades does not improve price discovery in the market, since the Proposals specify regulated pricing mechanisms that, in effect, make the mutual funds “price takers” rather than “price setters”: if an independently determined price is not available, then inter-fund trading is simply not permitted. Consequently, the price at which inter-fund trades occur is not meaningful information to the market.

In formulating new policy in areas such as inter-fund trading, we believe that regulatory consistency is an important objective. In our view, the inter-fund trading regime, as drafted, represents an unjustifiable and problematic anomaly in the web of existing securities regulations applicable to mutual funds. All of the provisions that govern mutual funds with respect to take-over bids, early warning requirements, insider reporting, ownership limits, and control blocks require mutual fund companies to aggregate their holdings, and to deal with and report their shareholdings as if they were a single position regardless of how many different funds may hold the securities. Under current legislation, this approach is justified on the basis that a single investment manager (or a group of affiliated managers) exercises discretion to vote, acquire, or dispose of the securities and so ought to be treated as a single entity. In other words, the CSA has taken the position that it is irrelevant to the market which specific mutual fund or account holds the securities. If this general regulatory principle is sound, then we would argue that it cannot be relevant to the market to know when securities are moved from one account or fund to another as long as they remain under common management and control. For example, even massive inter-fund trading would result in no change to insider reports. Accordingly, we submit that the printing of inter-fund trading information offers no benefit to the capital markets, even though it imposes real costs on mutual fund investors.

We strongly urge the CSA to carefully re-evaluate this regulatory inconsistency. If aggregation is deemed appropriate for general regulations such as insider reporting and early warnings, then we submit that aggregation is also the appropriate approach to take in connection with inter-fund trading, and by implication there is no merit to a printing requirement. If, on the other hand, the CSA believes that inter-fund trading information, whereby securities are merely moved from one account to another within a framework of a single investment management firm, is of value to the markets, then we submit that the logical corollary of that position is that aggregation is not the appropriate way to view the holdings of institutional investors and we would encourage the CSA to amend the existing regulatory framework to reflect this disaggregation principle. To require aggregation in some contexts (e.g. take over bids), but effectively impose disaggregation in others (e.g. inter-fund trading) seems to give mutual funds the worst of both worlds, in a way that is analytically unsound and inconsistent with the best interests of mutual fund investors.

If the CSA were to delete the printing requirements set out in s. 3.3(1)(c) of the Proposals, then the inter-fund trading regime would be substantially similar to the inter-fund trading rule used successfully in the U.S. We believe this would be a desirable outcome and we urge the CSA to consider amending the Proposals in this way.

Definition of Independence

The Proposals require that every IRC member must be independent. Although it is not clear to us that this independence requirement is either necessary or desirable, we do not object to the basic provisions of section 2.4. We are, however, concerned about the nature, extent, and severity of much of the "Commentary" that follows. Although the Proposals do indicate that the Commentary is not legally binding, we are concerned that the extensive commentary added to section 2.4 may, in effect, establish a very specific definition of "independence", which we would argue is too restrictive.

We believe that the first qualification for an IRC member is competence. While independence has a role to play, it is not a substitute for active engagement on key issues by an experienced person whose interests are aligned with the interests of long-term investors. An investor's best champion is an interested, engaged, and competent overseer.

We support the "principles" based definition of independence used in the Proposals. We would urge the CSA not to undermine the integrity and flexibility of this drafting by providing overly specific commentary. In particular, we would urge the CSA to delete paragraph 4 of the Commentary to section 2.4, which we suggest is unclear, overly specific, and excessively restrictive. We believe that there may be challenges to finding qualified IRC members in any case, but it will only be more difficult if, for example, there are broad, 3 year exclusions for anyone associated with a person who has been paid a fee of any kind.

As indicated below, we are pleased that the Proposals are generally drafted as "principle based" regulations; we would urge the CSA not to undermine the efficacy of this approach by inserting very specific and highly restrictive commentary, such as paragraph 4 to section 2.4.

Mandate of an IRC

The CSA's thinking with respect to fund governance has evolved since the release of Concept Proposal 81-402. The mandate of an IRC has shifted from a very general oversight function to being focused on conflicts of interest between the fund manager's own commercial and business interests and its fiduciary duty to manage its mutual funds in the best interests of those funds and their unitholders.

We believe that the CSA have strengthened the credibility of the IRC by adopting a more focused mandate which should permit an IRC to bring better analysis to important issues of investor protection. We support any initiative that will achieve real investor protection in a practical and streamlined manner and are of the view that a narrowed focus for the IRC is appropriate.

We are aware that some commentators may argue in favour of a much broader scope for an IRC, but we would encourage the CSA to resist these pressures. As we stated above, not all issues related to mutual funds are issues of governance, and it is clear that more governance does not necessarily prevent or reduce the number or types of concerns that can arise. Consequently, we would not support revising the Proposals to require an IRC to have a broader mandate than what is currently contemplated. Moreover, although we do not oppose the requirement in section 2.5(3) that an IRC must adopt a written charter that sets out its mandate and responsibilities, we would object to any interpretation of this provision that would allow an IRC to unilaterally enlarge its mandate or powers beyond what is specifically required by the Proposals, unless the fund manager agreed to such a change.

Output Regulation

As we have indicated in other contexts, Fidelity believes that it is generally preferable to frame legislation as “output regulation”, rather than detailed regulation of specific inputs. This approach is also referred to as “principle based regulation “. We are pleased to note that the Proposals are, generally, drafted as output regulations and we commend the CSA on their commitment to this approach.

Market Integrity

We believe that there are few regulatory objectives as important as enhancing and maintaining market integrity. We believe that the Proposals may enhance at least the perception of market integrity in the context of the Canadian mutual fund industry. This is, in our view, one of the primary benefits associated with the Proposals. As argued above, however, it is important that any benefit be considered in the context of the costs associated with it, and that regulations deliver benefits in a way that is as efficient and effective as possible.

Conclusion

Fidelity generally supports regulatory initiatives that enhance market integrity or improve the fairness and efficiency of capital markets, as long as they do so in a way that is effective and efficient. We do believe that fund governance may enhance investors’ perception of the integrity of the Canadian mutual fund industry, and we accept that this improved perception may be helpful to our industry. Nonetheless, we believe that it is essential that this benefit be evaluated in the context of the costs associated with it. Similarly, we believe that each of the specific provisions in the Proposals ought to be evaluated in the context of a rigorous cost-benefit analysis that considers the benefit of each such provision, including its importance to generating the overall benefits intended to be derived from the Fund Governance Proposals. We acknowledge that it may be difficult to meaningfully quantify the value of some benefits, but that challenge does not undermine the importance of the cost-benefit analysis. Each element of the Proposals should be retained only if it satisfies a robust CBA.

We believe it is important that the CSA complete a thorough CBA of the Proposals and allow that work to be scrutinized publicly. We remain concerned that not all aspects of the Proposals will satisfy the requirements of a strict CBA, and we hope the CSA remains open to amending the Proposals to reflect the outcome of that work. Although we have expressed particular concern with respect to the printing requirement imposed in respect of inter-fund trades, our CBA focus extends to all aspects of the Proposals.

Thank you for the opportunity to comment on the Fund Governance Proposals. We look forward to a continuing dialogue on these issues.

Yours very truly,

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