BMO Mutual Funds

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Via Email

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Re: Proposed National Instrument 81-107 – Independent Review Committee ("IRC") for Mutual Funds

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BMO Investments Inc. ("BMOII") appreciates the opportunity to offer comments with respect to the Canadian Securities Administrators (the "CSA") Proposed National Instrument 81-107 – IRC for Mutual Funds (the "Proposed Rule"). Four years ago BMOII participated in the initial fund governance survey, and since that time, we have worked as part of the Investment Funds Institute of Canada ("IFIC") Fund Governance Committee/Independent Review Committee to help provide further suggestions and insights into the issues of fund governance during the preparation of the CSA's 2002 Concept Proposal 81-402 as well as the Proposed Rule.

We strongly support the CSA's efforts to promote investor protection in mutual funds and to foster market efficiency in a practical manner. As such, we favour the establishment by the CSA of a requirement that all mutual fund managers be subject to the independent oversight and monitoring of an IRC. In fact, for many years now, we have had in place an independent governance agency that acts on behalf of our unitholders to provide independent monitoring and oversight of our management activities.

While we continue to support the CSA's efforts to improve mutual fund governance, we do have some concerns with the Proposed Rule and wish to offer the following comments:

Independence

We agree with section 2.4 of the Proposed Rule that all members of the IRC must be independent from the manager and the mutual fund. However, we are of the view that the Proposed Rule should define independence in a less restrictive manner. The persons referenced in Commentary 4 that would not be considered to be independent for the purposes of the Proposed Rule are extremely broad. In particular, a person is not independent if they have a family member that is an employee of the manager, the mutual fund or an entity related to the manager. We can see the sense in considering family members of an IRC that are officers or directors of the manager as not independent, but including all employees in this category is in our view over reaching. This may likely create problems for managers like us that are part of a large financial institution's group of companies. Given the significance of Canadian financial institutions as employers, many individuals may be excluded by such a broad definition of independence.

In addition, viewing potential members of an IRC that have accepted any consulting, advisory or other compensatory fee, particularly the indirect acceptance of such a fee, as not being independent is going too far. For example, a senior officer or partner of a service provider, such as a law firm or an accounting firm would be ineligible to serve as a member of an IRC where the firm has accepted a fee, even if the officer or partner was not directly involved in providing the service. This, in our view, is an excessive scope of inclusion. We worry that such restrictions will prevent many otherwise competent and knowledgeable individuals from being available to serve on an IRC.

In our view, the cooling off period in Commentary 4 (3 years) is too long and would also unnecessarily disqualify otherwise qualified persons from sitting on the IRC. We suggest a cooling off period of one to two years would be sufficient to satisfy any perceived conflicts of interest.

Commentary 2 to section 2.4 states that "the directors…of an entity related to the manager cannot act as the independent review committee since those directors will be considered to have a material relationship with the manager." In other words, the manager of a related corporate mutual fund cannot use the mutual fund's board of directors as the IRC. This appears to contradict Commentary 2 to section 2.1, which states that a mutual fund's board of directors may be used as the IRC. Investors already pay for the services provided by a board of directors and/or board of trustees, as these costs are reflected in the fund's Management Expense Ratio. It would, in our view, be a wasteful expenditure to duplicate these costs for investors by requiring the creation of a separate IRC where its functions can be fulfilled by an existing body (the mutual fund's board of directors and/or trustees). In addition, by including a fund's board of directors within the scope of a material relationship, the pool of competent and knowledgeable prospective IRC members is significantly reduced. Furthermore, we do not believe that

the board of directors of a manager or a special committee of that board, if completely independent, should be precluded from acting as the IRC. Again, cost savings and reduction of duplicative functions could be better achieved by adopting a less restrictive definition of independence. We ask the CSA to clarify their position on this issue.

Responsibilities

We believe that the best way for the IRC to fulfill its responsibilities would be by reviewing and approving the fund manager's policies and procedures in relation to conflicts of interest and related party transactions in advance and to thereafter receive quarterly reports and/or presentations by senior management to enable the IRC to satisfy itself that the fund manager is in compliance with such policies and procedures. We envision the IRC as operating in a similar capacity as the IRC's referenced in the self-dealing exemptive relief order granted to certain of our funds to enable them to purchase Bank of Montreal shares, and similar orders received by other funds operating under the same restrictions. In our view, the IRC should have the ability to review on an ad-hoc basis transactions that fall outside of the set policies and procedures when they deem necessary. In addition, the IRC should be free to establish its own guidelines as to what issues must be referred to it for a recommendation.

We believe that the IRC should be focused at the policy level to ensure that the fund manager has appropriate policies and procedures and that effective controls are in place to monitor compliance with these policies and procedures. We believe this will help achieve the goal of investor protection in a practical, efficient and cost sensitive manner.

Liability

There is currently no defined standard of liability (or limit of liability) within the Proposed Rule. If left undefined, the uncertainty as to coverage and cost will likely make it difficult to find suitable members to sit on an IRC, particularly as this is a new role for the mutual fund industry with no established precedents to follow. We are also concerned that liability worries may lead to micro-management by the IRC or spur the IRC to retain various advisors and independent counsel, which will inevitably drive up costs.

Conflicts of Interest

The definition of conflict of interest in section 3.1(2) of the Proposed Rule is far too broad. Almost any issue has the potential for conflict in cases like ours where the fund manager has a related portfolio advisor, underwriter and back office service provider and would therefore require review by an IRC. We do not believe it was the intent of the CSA that the fund manager should have to refer to the IRC all matters where there is a possibility for conflict to arise as this would likely result in daily meetings of the IRC which would be totally impractical and increase costs to be borne by the funds. We suggest that it should ultimately be left up to the IRC to determine what constitutes a conflict for that specific organization and consequently what situations should be referred

to it for recommendation as opposed to any rule that prescribes what must be referred to the IRC. This approach would be specific to the organizational structure of the fund manager and its business relationships and will likely result in a more efficient, streamlined and practical process for the entity involved as well as the IRC. That being said, we believe the manager should retain the ability to refer matters to the IRC that the manager views as a conflict of interest.

The inclusion of business conflicts in Commentary 4 to section 3.1, goes beyond the related party transactions and self-dealing provisions that are currently prohibited in securities legislation, and in our view, goes too far. We suggest that the CSA remove business conflicts from the Proposed Rule or, at the very least, only require a fund manager to adopt policies on certain matters such as allocating securities among mutual funds in a fund family, seeking best execution and soft dollar transactions.

Other Significant Issues

We wish to offer the following comments on several other significant issues:

Just as we see the appointment of the IRC as a prudent check on the activity of the fund manager, in considering appropriate rules regarding the appointment and compensation of IRC members, we believe that the CSA must be careful to ensure prudent checks are also in place to guard against abuse and/or conflicts of interest by IRC members. We believe the fund manager should be responsible for the appointment of all IRC members, not just initial members as indicated in section 2.2 of the Proposed Rule. We believe that placing the power to appoint in the hands of the manager may act as an appropriate safeguard on the IRC. For example, we recognize that allowing the IRC members to set their own compensation, as contemplated in section 2.7 of the Proposed Rule, creates an opportunity for abuse by the IRC members. However, we do understand concerns that an appearance of bias may result if the manager is allowed to set the salaries of those hired to supervise it. While not perfect, we believe that the ability of the manager to appoint IRC members will provide some check or assurance that the majority of IRC members will be able to reasonably police the activities of any 'rogue' member. We also believe that the appointment of IRC members by the fund manager would serve as a check to make it less likely that 'rogue' members could self perpetuate, or over time, form a majority.

In the alternative, we suggest that the fund manager be responsible for the appointment and compensation of all IRC members upon recommendation of the IRC members. The manager would ultimately make the final decision on such matters, however, if the manager does not follow the recommendation of the IRC, the manager would have to disclose this in its prospectus and continuous disclosure reports along with its reasons for not following the recommendation in the same manner as contemplated in section 2.11(2)(b).

We believe that the requirement in section 2.11(2)(c) for a mutual fund to disclose any report of the IRC that the IRC directs the manager to disclose in the prospectus and

continuous disclosure reports of the mutual fund serves no meaningful purpose and should be removed from the Proposed Rule. The inclusion of such reports will likely increase the length of the above-mentioned documents, which ultimately will result in increased costs to the funds.

It is our view that a change to the basis of the calculation of fees and expenses or the introduction of a fee or expense as indicated in section 3.2(1) 1 of the Proposed Rule should not be subject to securityholder approval. Instead, a fund manager should be able to increase fees and expenses by sending a notice to securityholders 60 days before the effective date of the change, and in these circumstances allowing a securityholder to redeem securities of that mutual fund and purchase securities of another mutual fund managed by the manager without payment of any fees.

Further Information

We thank you for the opportunity to submit our comments and trust that they will be given due consideration.

Should you have any questions, please call Darcy Lake, Director, Regulatory Affairs & Compliance at 416-867-5724 or Kim Cadario, Legal & Policy Counsel at 416-867-6455.

Yours truly,

“signed”

Edgar Legzdins