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John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th floor, Box 55
Toronto, ON, M5H 3S8
Telephone: 416-593-8145
Fax: 416-593-2318
e-mail: jstevenson@osc.gov.on.ca

and

Denise Brousseau, Secretary
Commission des valeurs mobilières du Québec
800 Victoria Square, Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Québec H4Z 1G3
Telephone: 514-940-2150
Fax: 514-864-6381
e-mail: consultation-en-cours@cvmq.com

Re: Canadian Securities Administrators ("CSA") Proposed National Instrument 81-107 – *Independent Review Committee for Mutual Funds* ("IRC")

We appreciate the opportunity to comment on the Proposed Rule and to work with the CSA in formulating an approach to improve mutual fund governance in Canada.

General

The overriding premise on which N1 81-107 is based is that there are significant inherent conflicts of interest that arise between the manager of the Funds and the investors in those Funds and that an independent committee will act to protect the interests of Fund investors.

While conflicts between the manager and the Funds themselves may exist, at least in theory, in practice the relationship is much more symbiotic than adversarial. Fund managers "make their living" by managing the Funds that "pay" them management fees and "reimburse" certain expenses. Assets under management are enhanced via good performance and new sales. The mutual fund industry is extremely competitive and, in many ways, very transparent. Most Fund "categories" have many, often hundreds, of Funds – performance, MER's, Management Fees, etc are disclosed, compared and ranked by analysts and fund monitoring services.

Fund investments are very liquid. If, for whatever reason, an investor is dissatisfied with their fund, such an investor can quickly and easily "vote with their feet". As has been shown by recent "scandals" in the mutual fund industry (in Canada and the U.S.) - reputation matters. Any hint of wrongdoing and funds flow out of the affected Fund (and/or fund family) very quickly.

Managers already have a fiduciary duty of loyalty and a duty of competence towards the Funds that they manage. A review of adherence to appropriate Policies and Procedures, perhaps even accompanied by a suitable report prepared by the auditor of the funds, may suffice. This idea is explored in greater detail later in this letter.

Costs and Benefits of an IRC

We would argue, albeit without hard empirical evidence, that the cost-benefit equation relating to the creation and functioning of an IRC as proposed in N1 81-107 does not favor investors.

The OSC's Cost-Benefit Analysis (proposed) of January 2004, sets out estimated costs for known or anticipated expenses such as IRC member fees, insurance, legal and administration costs. The per firm range is very wide - $348k - $2,167k for "large firms" and $202k - $686k for "small firms". While these costs may have been estimated at the higher end of likely ranges, there are several other costs associated with IRC's that have not been factored into the analysis. In particular, the IRC may engage legal counsel and/or independent advisors/consultants to perform analyses or provide requested reports. These services are usually costly and such costs would be borne by the funds.

The Mutual Fund Governance Cost-Benefit Analysis prepared for the OSC by Keith Martin (July 2003) estimates quantifiable benefits to the mutual fund industry as a whole of between $86 - $158 million per year. However, his analysis quantifies the "benefits" to funds from the removal of the 60-day rule and the impact of the current inter-fund trading rules. We would argue that those rules could be removed conditional on a suitable governance structure that is much simpler and cheaper than an IRC. With respect to the 60-day rule, in reality, fund managers are likely "far removed" organizationally from the underwriters of an offering and a suitable "Chinese Wall" structure may well suffice. In addition, it is only those fund families with a related underwriter/dealer that would really benefit from the removal of the 60-day rule. Re inter-fund trading, we comment on that in greater detail later.

While we concur that good governance is beneficial to investors in the funds, we question whether the establishment of an IRC really improves governance sufficiently to offset the costs for the benefit of such unitholders.

Nonetheless, there may be intangible benefits arising from the creation of an IRC such as greater investor confidence in the independence and integrity of the Fund Manager.

Authority of the IRC

The commentary (#2) to Section 2.7 (Authority) of the proposed Instrument suggests that "The manager should not pay any compensation directly or indirectly (by reimbursing the mutual fund) to the independent review committee……".

This statement shows a lack of understanding of how expenses are often charged to, and recovered from, mutual funds. While practice varies from fund manager to fund manager, the process described below is fairly typical. In all fund companies there is a "pool" of costs (overhead and administration) that are "chargeable" to the funds. Most fund managers manage a "family" of funds and these expenses are often not directly related to particular fund(s) but need to be allocated between all the funds (or even classes of Funds, as the case may be). The overriding principle is that the allocation methodology is fair and reasonable to all funds. Costs are thus entered into the "pool" which is then allocated on some rational basis. These allocated costs are then added to "direct" costs charged to the funds (i.e. costs that can clearly be identified as specifically pertaining to a particular fund) to give total expenses chargeable to a fund. When these expenses are added to the Management Fee for that fund (or class of fund) the total Management Expense Ratio ("MER") can be derived.

In many cases, particularly for smaller funds, the MER calculated in this way will be "excessive". In those cases, the manager may choose to absorb some expenses rather than passing them on to the fund in order to maintain the MER at a reasonable (competitive) level.

Thus, where an IRC is responsible for "overseeing" a family of funds, it is very possible that the fees and expenses associated with the IRC would indirectly end up being paid by the Manager, since they would go into the pool part of which is absorbed by the Manager.

Matters to be referred to the independent review committee

3.1 Conflicts of Interest

The Commentary to Part 3 – Matters to be referred to the IRC, lists several examples of business conflicts and of related party conflicts that could arise. There are potentially many others that have not been specifically identified. The risk arises that after a manager identifies all the areas of potential conflict that may arise in its business, that the IRC will end up "micro-managing" the business or business decisions that need to be made.

It would be preferable, more practical and more economical for the manager to develop appropriate policies and procedures for dealing with a range of matters that could lead to conflicts between the manager and the fund. Those policies and procedures would then be approved by the IRC with appropriate periodic compliance reporting of adherence to the policies by the manager, and/or internal audit and/or external auditors.

In this way the IRC would not need to deal with many matters at the "transactional" level since that may be too disruptive to the management of the funds and too expensive for the funds themselves.

While we would prefer to have the IRC deal with matters at a Policy and Procedures level rather than at a transactional level, we have commented on some of the specific items listed in the Commentary to Part 3:

3.1 Conflicts of Interest: Business Conflicts - The proposed N1 81-107 Commentary to Part 3 sets out some examples of business conflicts that may arise. Several of the examples listed pertain to the management of the investment portfolio of the fund such as allocation of securities, seeking best execution, proxy voting, etc. Any fund manager that also manages the investment portfolio of the fund is likely to be registered as an ICPM and would have a responsibility to act in his/her clients best interest in any event. Further, a distinction should be drawn between those fund managers who also perform investment management functions and those that outsource such functions to third party sub-advisors - what is the responsibility of the IRC where portfolio management activities have been outsourced?

3.2 Changes to the Mutual Fund

As discussed above, charging of expenses to the fund is a complex matter. As the manager of the funds, from time to time, a particular invoice may be received of a different nature or from a different supplier than in the past. In such cases, we will consider whether that expense is of a nature that it could be charged to the funds. To have to "refer" such decisions to an IRC is impractical and unnecessary and if the timeframe is such that a special meeting of the IRC would be required, the costs to the funds would also increase.

Further, since the allocation of expenses between the various Funds within the fund family involve a mathematical exercise, in many cases, changing or amending the formula will increase the potential costs to some funds while reducing the potential costs to other funds. Can the IRC decide on something that "favors" certain funds over other funds, i.e. are their responsibilities to each fund individually or to all the funds collectivity?

At a very minimum, the Instrument 3.2 (1) 1. should refer only to fees and not to expenses as well for the practical reasons discussed above. Fees should be subject to a notice requirement to security holders rather than a requirement to obtain securityholder approval. A manager should be able to increase the fees (price) of its product if it:

i) Sends a notice to security holders at least 60 days before the effective date of the change, and

ii) Allows a security holder to redeem securities of that mutual fund and purchase securities of another fund managed by the manager without payment of a fee.

<u>3.3 Inter-Fund Trades</u>

Given all the requirements relating to Inter-Fund trades proposed in the draft Instrument, (3.3. (1) (a) – (d)) the involvement of the IRC is redundant – compliance with the restrictions, processes and controls outlined in the draft Instrument should suffice. In addition, trading by portfolio managers often involves making timely decisions to take advantage of a perceived market opportunity. It may not be practical to have the IRC involved, in advance, of a proposed trade being executed.

Separate Auditors for the Fund Manager and the Mutual Funds

In most cases, both the Fund Manager and the Mutual Funds themselves are audited by the same audit firm. We believe that there are "independence" benefits from having separate audit firms for the Manager and for the Funds. For example, the auditors for a fund family will need to be comfortable with the formula used to allocate expenses to the various funds within the fund family. The audit firm is better able to do so if it does not audit the Manager as well since there may be benefit to the Manager to have more costs allocated to the Funds.

While this matter has not been previously addressed in the Proposed Rule, we feel that it warrants some consideration.

Thank you again for the opportunity to comment on the Proposed Rule.

Yours truly

"Steve Rostowsky"

Steve Rostowsky
Chief Financial Officer &
Chief Compliance Officer