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VIA ELECTRONIC MAIL

Ontario Securities Commission
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Attention: John Stevenson, Secretary

Autorité des marchés financiers du Québec
800, Square Victoria, 22e étage
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Attention: Denise Brousseau, Secretary

Dear Sirs:

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

I am responding to the request of the Canadian Securities Administrators (CSA) for comments on the proposed NI 81-107. The proposals in this national instrument provide, among other things, for an independent review committee for mutual funds.

I have given a lot of thought to the proposals. Unfortunately, I do not think that their implementation will serve the interests of investors, regulators or the capital markets generally. I recommend that they be withdrawn.

The following outlines my reasons for making this recommendation and includes some observations about various aspects of the proposals.

The CSA's recognition of the need for mutual funds to have an independent review committee (IRC) is a positive development. However, the implementing proposals negative any benefit.

If the proposals are implemented in their present form, there is a strong likelihood that they will undermine investor protection and erode confidence in the safety and soundness of mutual funds – the investment of choice for many Canadians. Indeed, the consequences of implementing these proposals have the potential to spill over and undermine the fairness and efficiency of the capital markets, confidence in these markets and Canadian productivity.

Capital market investments by mutual funds account for a large portion of the Canadian capital markets. Recent numbers released by The Investment Funds Institute of Canada (IFIC) indicate that the total mutual fund assets reported by IFIC members reached an all-time high of $466.2 billion at the end of February 2004. Most of these assets are held by Canadians who are saving for education, health care and retirement income. It is essential that their mutual funds be structured prudently and operated with the utmost good faith and integrity.

Those who establish and operate mutual funds and the regulatory system that oversees them must ensure that the interests of mutual fund investors are made paramount and protected in much the same way as the interests of deposit holders of financial institutions are protected. The consequences of failing to do so will go far beyond the immediate losses suffered by mutual fund investors. In addition to undermining capital market fairness, efficiency and confidence, the consequences potentially will create a societal problem that will undermine Canada's productivity as more tax dollars are required to be directed to social programs to support an ageing population that is unable to look after itself.

Fundamental Problems with NI 81-107 Proposals

There are two fundamental problems with the CSA proposals in NI 81-107 that give rise to the concerns expressed above. The first relates to the proposal to repeal the existing provisions that govern conflicts of interest. The second relates to the proposal to replace these provisions with a requirement that mutual funds have an independent review committee whose function will be to consider transactions involving conflicts of interest but with no power to constrain or otherwise limit or influence the transactions. The two problems are obviously related.

It is indeed difficult to understand how the CSA could conceive of the two proposals going hand-in-hand. The explanation (given in the CSA's discussion of the proposals) to the effect that the CSA views the repeal of the current prohibitions against self-dealing and other related party transactions as an appropriate trade-off for the industry's agreement to accept the requirement to have independent review committees whose authority is discretionary and non-binding, raises more questions than it answers. The trade-offs are disproportionate, inappropriate and unconscionable.

Furthermore, the characterization (by the CSA and its various spokespersons) of the proposals as "introducing a mandatory governance regime for mutual funds" places an unwarranted spin on them. So does the attempt to characterize the proposals as "an initiative to raise investor confidence". These characterizations border on questionable marketing practices. They are likely to have the opposite effect once the investing public realizes that the new regime has resulted in the elimination of the underpinnings of mutual fund regulation that have been put in place for investor protection and honed over years of industry experience. This regulation of mutual funds remains necessary even with the advent of IRCs and even with the advent of "principles-based" regulation.

The introduction of the requirement for mandatory independent review committees does not remove the necessity for prohibitions on self-dealing and other related party transactions nor the need for the investment restrictions and practices that have been adopted over the years to protect investors and to ensure the viability and integrity of mutual funds.

There is nothing new about "independent review committees" other than their name and the fact that it will no longer be optional to have one. Many fund complexes have had advisory committees or boards of governors in place for years whose functions have been similar to those contemplated in NI 81-107. Making this practice mandatory for publicly offered mutual funds is a logical next step and is consistent with the current governance focus on the need to introduce an element of independence into decision-making and the oversight process.

Whether this codification of the requirement for an independent review committee goes far enough is another subject altogether. I happen to think that more is needed. My thoughts in this respect are outlined in the Report I prepared for the CSA.[1]

Also, whether the current thinking on what constitutes "independence" is sufficient to introduce the appropriate element of independence into decision-making and the oversight process is another subject. I have some concerns about this that I will outline in my more specific comments about the proposed independent review committees.

The Need for a Combined Principles-Based and Rules-Based Regulatory Regime

The CSA's discussion of NI 81-107 indicates a desire to move towards a more principles-based regulatory regime than a rules-based one. As a person who finds the current rules as reconstituted during the last ten years virtually incomprehensible, I am certainly sympathetic. However, I do not think that eliminating the "rules" in favour of "principles only" is the solution.

Principles of regulation can and should co-exist with prescriptive requirements. It is not an either/or situation. The articulation of unambiguous principles of regulation supported by clear, plain and simple rules to implement these principles, will go a long way to overcome the mentality that approaches regulation from the perspective of “where does it say that I can’t do that?”.

There is little conclusive evidence to support the theory that a principles-based regulatory regime is preferable to a rules-based one. In fact there is evidence to the contrary. The pendulum swings both ways with the prevailing theory being dependent on where one is in the market cycles.

Right now, it is fashionable to blame the corporate scandals (wherever they have occurred) on the fact that there is a rules-based system of regulation rather than a principles-based one. Those doing so advocate getting rid of prescriptive requirements and replacing them with principles. This is short-sighted and reflects the thinking that is usually prevalent in bull market periods that free market forces will ensure fairness and integrity and eliminate the need for regulation. History has repeatedly shown that this is not the case.

Free market forces, whether or not they have been overseen or directed by boards or committees made up of persons who were considered to be independent, have given rise to the periodic problematic behaviour that has resulted in various legislative responses to curb such behaviour.

Examples of such legislative responses include the US Investment Companies Act of 1940, the amendments to Canadian provincial and federal statutes that were made in the ‘70s to prohibit, or severely constrain, self-dealing and related party transactions, the recent US Sarbanes-Oxley Act, and the current wave of statutory amendments and rule changes being proposed by the US Congress, the US Securities and Exchange Commission and various US self-regulatory organizations to regulate questionable conduct and practices in respect of mutual funds.

It would be disingenuous in the extreme to assert that the behaviour giving rise to the current responses in the United States to the questionable mutual fund conduct and practices that have occurred is unique to the United States and that such behaviour is not or could not be happening here. Now is not the time for regulators to relax rules or remove themselves from the oversight of investment funds.

1969 Canadian Committee Report

In contemplating the removal of the prohibitions against self-dealing and related party transactions, whether contained in statutory requirements or regulatory rules, it is useful to remember and heed the advice and recommendations contained in the 1969 Canadian Committee Report.[2]

The Canadian Committee Report rejected relying solely on a principles-based approach to regulating conflicts of interest. It opted for the combination of principles and rules that is reflected, for example, in the current provisions of Part XX1 of the Securities Act (Ontario).

These provisions include: (i) the articulation of a fiduciary standard of care; (ii) prohibitions on certain types of investments (both on an upstream and downstream basis); (iii) prohibitions against entering into arrangements where related parties receive fees or other compensation for services pursuant to contracts that are not disclosed in the prospectuses of their mutual funds; and (iv) disclosure requirements of certain transactions involving mutual funds and related persons or companies.

The concerns that the Canadian Committee were addressing in making its recommendations in 1969 still exist today. In fact the concerns have been aggravated by the intervening deregulation of the financial services industry which facilitated the ability of financial institutions to enter all aspects of the wealth management business and to make it their strategic imperative. The result of this deregulation has been continuous pressure on regulators to exempt companies within each financial complex from the prohibitions respecting related parties dealing with each other and from the reporting requirements.

By way of example, financial institutions want their controlled investment dealers to be able to sell securities they underwrite to their related mutual funds during the period of primary distribution and 60 days thereafter. Financial institutions and conglomerates want their related mutual funds to be able to make equity investments in related parties. They want their related mutual funds to be able to lend money to related parties. They want their related mutual funds to be able to deal with related brokers and investment dealers on a principal basis. They want their related mutual funds to make investments in entities where related parties receive fees or other compensation for services pursuant to contracts that are not disclosed in the prospectuses of their mutual funds.

Transactions involving related parties of the nature described above are what gave rise in the first place to the prohibitions contained in both Canadian and American legislation respecting mutual funds. Nothing has changed except the economic pressure being brought to bear by today's financial institutions and conglomerates. While the motives expressed in their exemption applications have an altruistic element, it is inappropriate, when dealing with the savings of vulnerable investors, to ignore that this altruism is accompanied by an element of self-interest and potential for abuse.

It is highly unlikely that an independent review committee of the type contemplated by NI 81-107 with no powers is a sufficient check or balance to warrant an exemption from the type of long-recognized problematic behaviour that is referred to in the Canadian Committee Report and in the prohibitions contained in securities legislation and regulatory rules.

The Canadian Committee Report and the statutory provisions that flowed from it contemplated circumstances in which the regulator could grant exemptive relief. These circumstances vary according to the type of relief applied for. They include satisfying the regulator that a class of investment or a particular investment represents the business judgment of responsible persons uninfluenced by considerations other than the best interests of a mutual fund or that a particular investment is in fact in the best interests of a mutual fund.

There may well be a role for an independent review committee to play in arriving, after due consideration, at such judgement and in seeking in appropriate circumstances exemptive relief based on such judgement. Unfortunately, the proposals in NI 81-107 do not provide for such a role. Nor do they provide for regulators retaining any regulatory oversight.

The Need for Regulatory Oversight

NI 81-107 is silent on the issue of regulatory oversight of mutual funds and IRCs. The Canadian Committee Report explicitly stated the need for the involvement of the regulator in any relief from the prohibitions and disclosure requirements concerning self-dealing and related party transactions.

The introduction of mandatory IRCs, particularly ones with no power, does not warrant (i) ignoring the Canadian Committee recommendations (which were reflected in the statutory amendments that were made following its Report); or (ii) the elimination of regulatory oversight; or (iii) the contemplated removal of the restrictions on investments and practices that have been developed over the years to protect the integrity and viability of mutual funds that are redeemable on demand.

Hope and Expectations

The CSA proposals in NI 81-101 use language indicating the hope and expectation of regulators. Hope and expectation are not a sufficient basis on which to found a regulatory regime to protect investors.

Enhanced Compliance

I have been told by regulators that they expect to enhance their compliance efforts. One has to ask just what it is they plan to do and how effective it will be absent any explicit requirements against which to measure compliance.

Other questions include: what resources and expertise exist among regulators to carry out their enhanced compliance efforts; what would the remedy for non-compliance be; how could it be enforced; how could investors be made whole; and the like.

Large regulatory fines and penalties or jail sentences do not benefit investors whose trust was abused and who have lost their savings or the opportunity to see their savings grow.

Once these losses have occurred, it is far too late to be reviewing what has transpired in the management of a mutual fund.

Before dismantling the existing regulatory regime for mutual funds, the public has a right to know just what role regulators see for themselves and how they propose to fulfill it.

The public also has a right to reasonable assurance that the regulators have adequate expertise and resources to timely and effectively protect investors who entrust their savings and future well-being to mutual funds.

With investigations and enforcement actions currently taking years to complete, the public's confidence in the new regulatory regime proposed by the CSA is simply not warranted.

Exemptive Relief

The mutual fund industry and regulators have expressed concerns about the burden and expense of obtaining exemptive relief from statutory provisions and rules regulating mutual funds. Regulators find exemption applications time-consuming and repetitive; sometimes they find it difficult to say no. Sometimes there is disagreement among regulators about whether exemptive relief should be granted.

None of these factors justifies the extreme measures proposed in NI 81-107 to dismantle the existing regime for mutual funds and leave it in the hands of individual fund complexes to establish their own regime free from any parameters other than a general expression of the fiduciary standard of care.

There are other measures that can be used to deal with streamlining and reducing the burden and expense of the exemptive relief process. These include seeking legislative authority (where needed) to grant blanket exemption orders and, as pointed out as far back as the Canadian Committee Report, moving to a single securities regulatory regime.

Self-Regulation

NI 81-107 by allowing each fund complex to set its own rules free of regulatory constraint effectively grants self-regulatory powers to mutual funds. At a time when the merits of self-regulation are coming under increasing scrutiny and question, it is odd that regulators are proposing such a move. This is particularly so when no self-regulatory organization is being created to provide the necessary structure, oversight and standards.

I cannot help noting an observation made to me by a former regulator who said: "I am always astonished when self-regulation in any industry is seen as a solution. It usually means that the regulator is unable to control the industry and gives up."

Anecdotally, I understand that in at least one jurisdiction where regulatory requirements for mutual funds have been relaxed, the resulting problems are leading to calls for better regulation and a re-examination of the merits of self-regulation.

Self-Interest

In considering the proposals in NI 81-107 to remove the prohibitions relating to self dealing and related party transactions, it is hard to ignore the fact that the major financial institutions and conglomerates are trying today to serve too many masters with the result that they are encountering conflicts wherever they turn. It is easy and trite to say that these conflicts can and must be managed. It is another thing to do it.

The example of Laidlaw Inc. was recently brought to my attention. Laidlaw was one of the most widely held Canadian companies and its biggest shareholders were bank-controlled mutual funds. These same banks were also Laidlaw's biggest lenders. When Laidlaw got into financial difficulties, the issue was whether the banks protected their loans or worked to protect the interests of the shareholders who included their managed funds. The banks opted to protect their loans. It is simply not realistic to expect that banks will stand up and fight on behalf of shareholders when their own money is at stake.

Another example that was cited to me involved the attempted takeover by Onyx of Air Canada a few years ago. Banks with large loans outstanding used their power to marshal the voting rights to Air Canada shares owned by various managed accounts.

Yet another example of troubling conflicts is seen in the apparent involvement of banks (and others) in transactions that have resulted in the recent charges and allegations of wrong-doing against them in relation to the mutual fund scandals involving market-timing and late-trading in the United States. It would be nice to think that such conduct is not and could not be happening here but such an assumption is probably a naïve one.

It is simply unrealistic to expect that people's interests will always be parallel and can be managed so that the results are in everyone's best interests. This is why one of the principles underlying fiduciary obligations is that a fiduciary should not put itself in a position where its interests conflict with its fiduciary duties.

These examples of conflicts (which for the most part fall outside the current statutory prohibitions) are another reason why it is inappropriate to add to the type of conflicted transactions that can be entered into by removing the current statutory and regulatory prohibitions.

Independent Review Committees

I have several concerns about the proposals for independent review committees. These mostly relate to the absence of the IRC's ability to deal effectively with the manager on matters where it considers that the best interests of investors in the manager's managed funds are not being served.

Disclosure of these disagreements or concerns in a prospectus or annual report is not likely to be an effective remedy. For the most part, this disclosure will probably come too late and may not be specific enough to be of much use to investors. Another problem is that while facts are often given in disclosure documents, no disclosure is made of the likely impact of these facts on investors.

Even more problematic is the fact that investors will not likely receive any disclosure that is made because regulators, through exemption orders and proposed rule changes, no longer require these documents to be given to investors unless they expressly ask for them. It is also unlikely that investors will know what to do about the matter even if they do find out about it.

Unfortunately this is an area where it is unlikely that investors will receive much help from their financial advisors. This is due to the fact that so many financial advisors work for or represent organizations that are part of the fund complex. There are few financial advisors who will have the ability or the freedom to evaluate and compare mutual funds in respect of their governance standards and the impact on performance and investors.

Another problem which flows from the ability of each IRC to set its own parameters is that there will be no basic common standard that investors can expect or rely upon to be reasonably assured of the integrity and viability of a mutual fund as an appropriate vehicle to which to entrust their savings. There is no analytical service that evaluates and compares mutual funds in respect of their governance standards and their impact on performance and viability. It is unlikely that any such service will develop given the lack of independence that permeates the industry and the lack of funding for independent research of this nature.

Another major area of concern relates to the concept of "independence". The absence of defined relationships is no assurance of independence. Independence involves much more. It flows from the ability to think independently, understand the business enterprise and apply critical, independent judgment to decision-making.

An important dimension of independence that has not been given much weight is the materiality to the committee member of his or her position as a committee member. Prestige and income concerns can skew objectivity and independence just a much as any other type of conflicted relationship.

An important qualification for membership in an IRC should be an understanding of the mutual fund industry, the financial services industry and how it operates. "Industry literacy standards" are as important to a member of an IRC as "financial literacy standards" are to a member of an audit committee. Retired politicians, government bureaucrats, chartered accountants, consultants and lawyers (from whose ranks IRC members appear to be chosen) bring their own expertise; it just may not be the expertise that is needed.

It is essential that people serving on an IRC successfully complete industry awareness and training courses designed to equip them with the background knowledge and skills to play a meaningful role in overseeing the fund manager's activities in respect of its managed funds.

There is also a concern that IRCs may for a variety of reasons simply become "rubber stamps" for management proposals. There is concern that the boardroom culture that has given rise to a variety of corporate scandals (including the high compensation being paid to directors and senior officers) may result in members of IRCs putting the fund manager's interests ahead of those of mutual fund investors. Concerns such as these make it imperative that there are clear constraints, principles and rules (as discussed above) embedded in the regulatory regime to serve as a check and balance.

Another drawback of the CSA proposals is that here is no mechanism for investors to participate in the appointment of members of the IRC. I am well aware of the apparent lack of interest of investors in attending annual meetings or returning proxies but that is no reason to eliminate or not provide for a right to vote.

Another area that is problematic is just how many IRCs a member can serve on and still be considered "independent". A member of an IRC should have a duty of loyalty to the specific investors whose money is at risk in a particular fund. It is conceivable that IRCs will find themselves in conflict when they serve too many funds or where they serve funds (including classes or series within funds) whose interests may diverge.

To be truly effective and a watchdog for the interests of fund investors, IRCs will need to drill down into the details of how various transactions are actually handled and to deal with the issues before they happen rather than after the fact.

This is one reason why I find the proposal for fund managers to share an IRC with other fund managers troubling. It seems to contemplate a very high level of oversight without offering any hands-on review of what is actually transpiring or whether the systems, standards and procedures that are in place are actually effective in protecting investor interests. This proposal also seems to be an indirect way of arriving at a "self-regulatory organization" for mutual funds, devoid of basic common standards and the appropriate constraints.

I find it troublesome that the costs of keeping the manager honest are being passed on to fund investors. Somehow, these costs should be ones that investors should reasonably be entitled to expect are included in the services provided by the manager for its fees.

Another cost that investors should not have to bear is the deferred sales charge if they redeem their units because of fundamental changes that the manager decides to make in its managed mutual funds.

There are other matters that I could raise in relation to the proposals for IRCs but they are of a more detailed nature that would better be left pending a decision of whether to proceed with the proposals.

Remedies

Another problem with the proposals in NI 81-107 is that they do not sufficiently address the practical ability of investors who incur losses as a result of the fund manager's breach of its fiduciary obligations to seek redress. This existing problem is aggravated by the CSA's proposals to eliminate current regulatory prohibitions and restrictions. The result is that it will likely be more difficult for investors to establish a breach and it will be costly. Class, and other types of legal, actions offer more of a theoretical remedy than a practical one. In addition, anyone bringing such actions runs the risk of being sued for interference with economic activities, defamation and/or other alleged wrongs.

Again, one of the reasons that the Canadian Committee Report recommended the current statutory provisions to deal with self-dealing and related party transactions is that it regarded the standards then embodied in existing legislation and case-law as inadequate, and concluded that a standard of transactions that are to be regarded as abusive and applicable to all mutual funds should be embodied in legislation.

Regulators and Legislatures

Regulators and legislatures should not abandon investors to the self-interest of fund complexes and financial conglomerates who are more focused on their bottom line than those of the investors in their managed funds.

Costs and Benefits

In measuring the costs and benefits of NI 81-107, it is important to take into account the costs that investors will occur in seeking redress as well as losses that they are likely to incur as a result of the proposed deregulation.

Due Process

Another troubling aspect of the controversial proposals in NI 81-101 is that they have largely been implemented by exemption orders granted to the fund industry. These orders have been granted without notice to the public or the opportunity for the public to comment on exemptive relief being given. This compromises the genuineness of the comment process contemplated by the legislature and makes it moot.

This is a very serious issue that goes to the heart of regulatory accountability, a subject that merits increased attention both from regulators and the legislatures.

Conclusion

Neither investors nor the fund industry will be well-served by implementing NI 81-107. I recommend that it be withdrawn.

Ten years ago I made extensive recommendations for enhancing mutual fund governance. Five years ago I reinforced these recommendations in a second report prepared for Industry Canada's Office of Consumer Affairs.[3] Over the years I have spoken extensively about the subject. The recommendations I have made still offer regulators and investors a sound governance framework.

I would be glad to discuss any aspect of the foregoing with you and to assist in any way that I can in moving this matter forward.

Yours very truly,

Glorianne Stromberg

[1] *Regulatory Strategies for the Mid-90s - Recommendations for Regulating Investment Funds in Canada*, prepared for the Canadian Securities Administrators, January 1995. (Available in electronic form at <http://www.osc.gov.on.ca>)

[2] Report of the Canadian Committee on Mutual Funds and Investment Contracts – A Provincial and Federal Study 1969 published by the Queen's Printer for Canada

[3] *Investment Funds in Canada and Consumer Protection - Strategies for the Millennium*, a Review by Glorianne Stromberg prepared for the Office of Consumer Affairs, Industry Canada, October 1998. (Available in printed form from Industry Canada's Information Distribution Centre by calling (613) 947-7466 and in electronic form at http://strategis.ic.gc.ca/SSG/1/ca01120e.html)