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April 16, 2004

BY ELECTRONIC MAIL

Mr. John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario
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- and -

Ms. Denise Brousseau, Secretary
Autorité des marchés financiers
800 Victoria Square, Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Quebec
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Dear Sirs/Mesdames

Re: ***Proposed National Instrument 81-107 Independent Review Committee for Mutual Funds—Comments of Borden Ladner Gervais LLP***

Thank you for the opportunity to provide our comments on proposed National Instrument 81-107 *Independent Review Committee for Mutual Funds* (referred to herein as 81-107, the Rule or the Proposal) of the Canadian Securities Administrators (CSA). We also respond herein to the questions posed by the British Columbia Securities Commission (BCSC) in connection with the Proposal, which were published by the BCSC in Appendix A to BC Notice 2004/03 on January 8, 2004.

Our comments on the Rule do not necessarily reflect the opinions of, or feedback from, our mutual fund clients. We expect that many of our clients will express their views directly with the CSA.

Our comments on the Rule have been compiled with input from many of the lawyers in our National Investment Management Group and therefore reflect our collective views. We have been closely following the developments in fund governance leading up to your most recent release and since its release, we have considered how we would advise our clients on the practicalities of implementing the Rule, assuming it comes into force. As you know, two of our partners, John Hall and Lynn McGrade, are members of the *ad hoc* mutual fund governance committee organized by the Ontario Securities Commission in

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2002 following publication of the CSA fund governance Concept Proposal. Rebecca Cowdery, the project leader on the fund governance proposals at the Ontario Securities Commission until the end of June 2003, joined our Toronto office in November 2003.

Given the CSA's stated objective of introducing independent fund governance to the Canadian mutual funds, overall, we support many of the concepts comprising the regime proposed in the Rule. We view fund governance as an important pillar (using the CSA's terminology) of the Canadian regulatory regime, but we strongly believe that fund governance should not be considered an "add-on" to the existing regime. We believe that all existing regulations must be reviewed in light of the Rule. As such, we would have preferred to review the Rule as part of a complete package of revisions to the existing regime. As you have not published amendments to the conflicts regime (part of Pillar 2 of the Concept Proposal) or to product regulation (Pillar 3 of the Concept Proposal), it is difficult to properly comment on the Rule, since we cannot consider or quantify the complete cost-benefit equation or fully comprehend the context for the Rule. However, with these caveats and subject to our comments outlined in this letter, we believe that the Rule represents a measured and largely comprehensive regime for independent fund governance.

Given our role as lawyers for our mutual fund clients, we have commented primarily on matters that we believe, from a practical or technical perspective, need revision in order to achieve the CSA's stated objectives. We know that others in the industry will be commenting on the CSA's proposals, both pro and con, from a broader policy point of view. We felt that we could add more value in commenting on ways to improve the Rule as written, so that the CSA's concept of improved fund governance can be reasonably and practically achieved.

We have commented on the Rule in section order and in so doing have commented on many of the questions the CSA posed in the Proposal.

Before beginning with our comments on Part 1, we note that we support the revised style of the CSA to provide policy on the rules via Commentary that follows a specific rule, rather than setting out CSA policy in a separate companion policy. The revised style of the Rule leads a reader to better understand the CSA's intentions with respect to a particular rule, than the existing more formal, legalistic national instruments and companion policies.

Part 1 Definitions and Application

1.1 Definitions
1.2 Mutual funds subject to Instrument

As drafted, 81-107 would apply to most publicly offered mutual funds (as defined in securities regulation) and their managers, but would not apply to labour sponsored investment funds, mutual funds that are listed on stock exchanges or mutual funds that are "not governed" by NI 81-102. You have specifically asked for comment as to whether 81-107 should apply either more broadly or more narrowly, but have not otherwise explained why the Rule will not apply to those excluded investment funds.

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Currently, there is limited guidance from Canadian regulators with respect to their expectations for governance for investment funds that are not public mutual funds, such as closed end funds, hedge funds, pooled funds and scholarship plans. Because the corporate governance rules adopted earlier this year by Canadian regulators and the corporate governance disclosure rule and policy published for comment, expressly do not apply to investment funds, governance of investment funds not covered by 81-107 will be essentially unregulated beyond general fiduciary standards of care. We question whether this regulatory gap is desirable.

In our view, the governance model proposed in 81-107 would, with little or no modification, apply to other types of investment funds. Given this, regulators should, in our view, give consideration to extending the application of 81-107 more broadly, especially to other types of investment funds that are offered publicly. This would create a more level playing field among investment products and send a signal to the marketplace that retail investors in any public investment fund in Canada will have the protection of a "made in Canada" fund governance model.

1.3 Multiple class mutual funds

We note that this section appears intended to have the same result as section 1.3 of National Instrument 81-102 *Mutual Funds*, but introduces new concepts and uses different terminology, which we submit is not desirable. You have not explained why this change is being proposed. However, we submit that industry participants, including their legal advisers, are confident that they understand how section 1.3 of NI 81-102 operates. The approach to identifying what constitutes a fund in section 1.3 of NI 81-102 is clear and provides certainty. We are less certain about new section 1.3 of 81-107 and we strongly recommend that 81-107 simply refer back to the test provided for in section 1.3 of NI 81-102 and provide that the same test applies to 81-107. We do not think it desirable for two national instruments to regulate the same matter, but use different concepts and words.

Part 2 Independent Review Committee

2.1 Independent review committee for mutual funds

We agree generally with the thrust of section 2.1, namely that a fund manager should have the flexibility to establish an IRC with a structure that works for its mutual funds. We believe, however, that it would undesirable for a fund manager to establish more than one IRC for different funds within the same mutual fund complex for the following reasons:

(a) Having several IRCs may be counterproductive as they may each establish different guidelines and take different approaches on matters referred to them by the same manager. Except in circumstances in which reasons for different treatment would be obvious, we believe that, generally, there should be uniformity with respect to policies and procedures for all of the funds managed by the same manager.

(b) Fund expenses would increase, likely substantially, if there were several IRCs.

(c) It is anticipated that many fund complexes will experience difficulty in identifying and attracting suitably qualified individuals to serve on IRCs and having several IRCs would obviously compound this problem.

In the case of large fund complexes it may be more appropriate to have an IRC that consists of a larger number of members. In such event, sub-committees could be set up to deal with specific issues when required.

The Commentary suggests three alternative legal structures for an IRC. We agree with the approach of the CSA not to mandate a specific structure, but we make some observations on the alternatives put forward by the CSA. The first alternative structure, "individuals appointed as trustees for the mutual funds", would not generally be considered suitable, as "trustees" of mutual funds generally play a different role, with a greater potential exposure and other fiduciary duties to the funds. On the second alternative, "the board of directors, or a special committee of the board of directors of a registered trust company", we note that, in practice, many mutual funds in Canada do not have a registered trust company acting as trustee and therefore, we don't believe this suggestion will be often used, in practice. The third alternative of establishing "a committee of individuals, each of whom is independent from the manager" would appear to be the one that most fund managers will chose.

To be effective, an IRC member will work to develop a good understanding of the internal workings of a fund manager's operations and will be privy to a great deal of proprietary information. For this reason, we do not believe fund managers will consider an IRC acting for two or more different fund complexes to be a viable alternative (as suggested in the Commentary) as this in itself could result in conflicts of interest and confidentiality concerns.

2.2 Initial appointment

From a practical perspective, we support the Rule requiring the fund manager to appoint the first members of the IRC and the IRC to thereafter fill vacancies.

2.3 Composition, Term of office and vacancies

Commentary 1 suggests that the manager should advise the securities regulatory authorities of the reasons for a mass resignation of the members of the IRC. We feel readers of the Rule and Commentary would benefit from understanding why this is recommended and what the securities regulatory authorities would do with this information. We recommend that additional information be provided in the Commentary.

2.4 Independence

We have restricted our comments on this section to practical comments only, although we note that the presence of non-independent members on an IRC may allow the other members of the IRC to better understand the business of the fund manager and matters

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relating to a specific conflict of interest referred to the IRC and we recommend that the CSA re-consider the concept of 100 percent independence on the IRC. We note that the reforms of mutual fund governance in the United States suggest that the U.S. regulators and industry, believe that mutual funds and their investors benefit from the presence of non-independent directors on a fund board. The Report of the Advisory Group on Best Practices for Fund Directors entitled *Enhancing a Culture of Independence and Effectiveness* released in June 1999 (and still in use today) discusses the benefits of having non-independent members on a fund board in conjunction with the recommendation that at least two-thirds of the directors of investment companies be independent directors (at pages 11 and 12).

Section 2.4 requires amendment to ensure that there will be an adequate pool of qualified individuals who would be considered to be "independent" within the meaning of the Rule. Without the amendments we describe below, we believe the pool of qualified individuals will be severely limited. As drafted, section 2.4 would unnecessarily preclude many experienced individuals from serving as members of an IRC.

Section 2.4 should be modified to conform it to Multilateral Instrument 52-110 *Audit Committees*. In particular, we urge the CSA to introduce the "prescribed period" concept that is found in MI 52-110, in that individuals should only be considered non-independent for the purposes of the Rule, if they have or have had a specified relationship during the prescribed period that begins ***after*** the Rule becomes final. Individuals should not be barred from acting as IRC members because they are "tainted" by relationships that pre-dated the Rule. The same rationale for introducing this concept to the Rule exists as for MI 52-110. We expect that including this essential amendment will negate comments about the undue length of the "cooling off" period.

Section 2.4 must be amended to allow individuals that today act as the independent directors on the board of a fund manager to become the first independent members of an IRC for the mutual funds managed by the fund manager, so long as these individuals have no other material relationships within the meaning of 81-107. From a pragmatic perspective, these individuals, who have often been appointed to the fund manager's board as an additional check and balance on the fund manager (that is, as a quasi-IRC), should not be tainted by this association and barred from acting as members of the IRC. Many of our clients appointed independent individuals to their boards of directors in anticipation of the CSA's improved fund governance proposals and are dismayed by the prospect that these knowledgeable and experienced individuals will be tainted and not permitted to move over to form part of an IRC for their funds.

Similarly, section 2.4 should be amended to clearly allow a director of a corporate mutual fund to also act as a member of an IRC for that mutual fund and the other mutual funds managed by the same fund manager, so long as that individual has no other material relationships. We do not believe this relationship in of itself would fall within the prohibitions in the Rule, but Commentary 4 would appear to bar these individuals (through the reference to "the mutual fund" in the first bullet).

We also question whether the Commentary on the Rule means that an individual who has an investment in a particular mutual fund would be regarded as having a "material relationship" with that fund and so be disqualified from being a member of an IRC.

Provided there is no other reasons for that disqualification, we believe such individuals who are otherwise qualified should not be prevented from becoming a member of an IRC simply because of that investment. We note, in this context, that generally holding securities in the mutual fund(s) will serve to better align the interests of the IRC member(s) with the mutual fund(s).

While generally it would not be inappropriate for an IRC member to hold securities in a mutual fund for which he or she acts as an IRC member, we recommend that the Proposals suggest that each IRC should adopt policies and procedures to require disclosure of each IRC member's interests in those funds. We believe, as a matter of good governance, that an IRC member should recuse himself or herself from participating in any decisions relating to funds in which he or she holds substantial interests. Similarly IRCs should consider policies to deal with ownership of interests in mutual funds by close relatives of IRC members in cases where such ownership could be considered to impact a member's discretion. We note that it would be appropriate for the significance of an individual's interest to be measured as a percentage of the individual's net worth, and not as a percentage of the securities of the mutual fund held. Perhaps the CSA intended paragraph 6 of the Commentary to section 2.4 to deal with the concepts we describe in this paragraph; if so, we recommend this be clarified.

Finally, we suggest that a form of "materiality test" be introduced as part of section 2.4(3), so that the phrase "any relationship" is qualified. This comment also applies to paragraph 4 of the Commentary, particularly as it refers to direct or indirect acceptance of "any consulting, advisory or other compensatory fee". In our view, this Commentary has a very sweeping scope—one that will disqualify most lawyers and accountants that work in firms that have mutual fund manager clients even where the billings may be insignificant and the work performed by other lawyers or accountants, potentially in offices located in different municipalities. The broad language used in the Commentary also seems to be inconsistent with the clear concept of materiality expressed in the Rule itself. We trust that when the CSA conform 81-107 to MI 52-110, this rule and Commentary will be modified.

2.5 Responsibilities

We submit that the phrase "provide impartial judgment" be deleted from the Rule. An independent IRC member will provide "impartial judgment" because of his or her duties owed to the funds and because that member does not have any relationships that would taint that judgment, but we believe this phrase is not capable of being precisely defined and therefore should not be included in a binding, and enforceable, rule. How would the CSA ever take any enforcement action against an IRC member for failing to provide "impartial judgment"? We also believe this phrase is not necessary, since the independent IRC members will be independent of the fund manager and the duty of the IRC will be to recommend what would be a "fair and reasonable result" for the mutual fund. Furthermore, each IRC member will be required to follow the standard of care provided for in section 2.6. If the CSA consider that it is important to include this phrase, we believe it would be more appropriate to include it as part of the Commentary, along with an appropriate explanation as to its intended meaning.

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We note that there is no provision analogous to subsection 2.5(2) of 81-107 in Multilateral Instrument 52-110 *Audit Committees* and question why this subsection is necessary for the Rule. Although there may be occasions where an IRC may wish to deliberate or make decisions without representatives of the manager being present, there may be other times when such presence is desirable. The decision to include or exclude the representatives of the manager from the IRC's proceedings should be left to the discretion of the IRC. If subsection 2.5(2) of 81-107 is to be retained, we believe paragraph 2 to the Commentary should clarify that the IRC can meet with representatives of the manager or any entity related to the manager to discuss any matters before the IRC, provided that the final discussions and decisions are made in the absence of such representatives.

If the CSA decide to retain the concept of "shared" IRCs (and as we point out in our comments, we do not believe this is a practical suggestion), the Commentary should clarify that a separate charter for each fund family is necessary.

2.6 Standard of care

We have no comments on this section, which we believe is appropriate, other than to note that we recommend paragraph 2 of the Commentary be deleted as unnecessary (it doesn't add anything more than what is written in the Rule and contains somewhat awkward phrasing that adds an element of uncertainty to the Rule).

2.7 Authority

Members of an IRC should have the ability to require the fund manager or the fund indemnify them in appropriate circumstances. Accordingly, we recommend that the following new paragraph be added to section 2.7:

> (d) require the mutual fund and/or the manager to indemnify its members against all costs, charges and expenses, including amounts paid to settle an action or satisfy a judgment, reasonably incurred by a member in respect of any civil, criminal, administrative, investigative or other proceeding in which the member is involved because of his or her association with the IRC, provided that the member meets the requirements of section 2.6 [standard of care].

With respect to the Commentary on compensation of the IRC and in particular, the prohibition on the payment of indirect compensation to the IRC by the Manager, we are concerned that this could disproportionately increase the management expense ratios of smaller funds since managers of such funds often absorb some of the costs incurred by those funds in order to maintain a competitive MER. We also point out that fund managers do not generally "pick and choose" which fees and costs charged to a mutual fund to absorb. They generally absorb a portion of all costs and expenses so that the fund's MER is kept to a reasonable level. This practice should be viewed as positive and in the best interests of the funds. From a practical perspective, this prohibition will require fund managers to absorb more of the non-governance expenses, to achieve the

same result, a competitive and reasonable MER. In our view, this prohibition will not make the IRC more or less independent, from a practical perspective. We recommend that a fund manager should still be able to continue to absorb fees of the fund (which will include the new fund governance expenses) so as to maintain a competitive MER, in the discretion of the fund manager and subject to any usual disclosure requirements (as set out in National Instrument 81-101).

The Rule also provides unfettered discretion to the IRC in setting their compensation and incurring expenses. Although we understand that this Rule is designed to maintain the independence of the IRC from the fund manager, we believe checks and balances on the cost of an IRC would be in the best interests of a fund. Accordingly, we believe that the IRC should be required to consider a recommendation from the manager on the appropriate level of compensation for IRC members and the overall level of expenses borne by the funds and, in the event that the IRC rejects the manager's recommendation, this fact, together with the total amount of expenses incurred by and compensation paid to an IRC, should be disclosed in the funds' continuous disclosure documents.

We recommend two other amendments to the rule allowing an IRC to set its compensation (which will then be paid for out of fund assets)

(a) The fund manager should be permitted to allocate the governance expenses among the applicable mutual funds in a fair and equitable manner and

(b) 81-107 must provide the mutual funds and the fund manager with an exemption from Part 5 of NI 81-102 and its requirements to obtain security holder approval before the additional governance expenses could be charged to the mutual funds and before any increase in these additional governance expenses could be charged. If this exemption is not built into 81-107—and we view this exemption as essential and technically required in order to achieve the CSA's objectives—then all mutual funds in Canada would be required to hold a security holder meeting before they could comply with the law once 81-107 comes into force. We doubt that the CSA intended for this result.

2.8 Liability

You have asked two questions under this section, the answers to which, we believe are quite self-evident. Undoubtedly, potential members of an IRC will be reluctant to join an IRC if their liability is uncertain. In the corporate context, there is a well-developed market for directors and officers insurance, but we understand fund industry participants are concerned about the availability and cost of such coverage for IRC members in view of the novelty of the IRC and the absence of any claims history on which to price such insurance. As professional advisers, we would be reluctant to advise a client to join an IRC if there were no limits set on personal liability and no insurance coverage in place to protect IRC members against possible litigation or otherwise. We believe that the liability of IRC members should be limited to a reasonable amount, provided, of course, that the CSA have the authority to make such a rule.

2.9 Proceedings

We agree with the proposed rule that an IRC must maintain a record of its written charter, minutes of its meetings and its reports and recommendations.

However, where an IRC is shared with another fund manager or managers, the maintenance of records may be problematic and cumbersome. For example, because the written charter is meant to be drafted to take into consideration the specific conflicts to which the manager is subject, it may be difficult for one charter to properly address the special considerations of each fund family. Similarly, it may be impractical to maintain multiple sets of records, each set relating to specific set of conflict issues of a fund family and the minutes, reports and recommendations to resolve those conflicts. This, in turn, may act as a disincentive for managers to share an IRC, and thus, act as a barrier to a more cost effective means of setting up an IRC.

If the written charter is left more generic in nature, then detailed policies in respect of each fund family will be necessary.

2.10 Ceasing to be a member

We recommend three additional circumstances in which an individual would cease to be a member of an IRC be added to the Rule:

(a) The manager should have the ability to terminate an IRC member when he or she moves outside of the jurisdiction where the manager is located. This would address those situations where it becomes impractical and expensive to retain a member who is no longer resident in the local jurisdiction.

(b) All IRC members should be terminated where there has been a change in control of the manager. The Rule currently recognizes circumstances where the fund manager changes; we believe the Rule needs to recognize the more common circumstance, where ownership of the fund manager changes. We note that the Commentary appears to recognize changes in control, but the words used in the Rule "change in manager" do not appear to be broad enough to include changes in control of the manager.

(c) An IRC member should be terminated if he or she joins the board of directors of, or advisory committee to, another mutual fund manager. The Rule should allow the IRC to re-appoint this member, but only if the fund manager agrees to such re-appointment in light of that member's duties to the other (competitor) fund manager. In our view, it should be open for a mutual fund manager to refuse to have a member of a governance agency of another fund manager act as IRC member for its mutual funds, since that member may have divided loyalties—to the other mutual fund manager and to the mutual funds for which he or she acts as IRC member. A fund manager may view this conflict as just as important as the conflicts that would arise if that IRC member were also a member of the fund manager's own board of directors. Although, we feel less strongly about

this next circumstance, we also suggest the CSA consider whether the same approach should be taken when an IRC member becomes a member of another IRC.

Under subsection 2.10(2), the manager has the ability to call a special meeting of securityholders of the mutual fund for the purpose of removing an IRC member or members. We foresee the possibility that a manager could call, or threaten to call, a meeting for the purpose of removing IRC members and then appointing new ones. Meetings would, in practice, begin to resemble hostile transactions in which both the manager and IRC solicit proxies prior to the meeting. We recommend that additional guidance be provided for these types of special meetings, particularly the expectations for fund manager action and IRC member "counter-action".

2.11 Disclosure

Although we agree with summary disclosure on the IRC and its mandate in a mutual fund's disclosure documents, we do not agree that disclosure of the individual IRC members and changes in IRC composition are necessary, particularly, if the CSA intend this disclosure to be part of today's simplified prospectus. We also recommend that the CSA re-think the concept of including a summary of the IRC mandate, along with a list of IRC members in each "periodic continuous disclosure" report. We believe this disclosure would be very repetitive and would become quite boilerplate and meaningless. We believe disclosure should be about material matters, and in our view, the most material matter is that provided for in paragraph 2.11(2)(b).

We also recommend that section 2.11 be deleted in its entirety and these revised disclosure and continuous reporting requirements be addressed as part of amendments to NI 81-101 and implementation of NI 81-106.

Part 3 Matters to be referred to the independent review committee

3.1 Conflicts of interest

We understand that the CSA have two primary goals for section 3.1:

(a) the fund manager will retain the responsibility and accountability for managing its mutual funds according to its prescribed standard of care, and therefore will continue to make decisions about its mutual funds, even in circumstances when it has a conflict of interest, provided it meets that standard of care; and

(b) recognizing that, in conflict situations, a fund manager may not be able to be objective about making a decision that is in the best interests of the funds, the fund manager will be required to take the recommendations of an independent review committee (based on their views of what would be fair and reasonable for the mutual funds) into account in making the decision. This will introduce independent judgement into conflict situations, which is expected to benefit mutual funds and their investors.

Overall, we agree with these objectives. We also agree with the basic structure of section 3.1 in that it puts the onus on the fund manager to refer matters to its IRC and make decisions about its mutual funds in accordance with a prescribed standard of care, but also taking into account recommendations from independent persons.

However we believe modifications to this section are essential so that these objectives can be met in ways that are achievable in practice. Certain of our comments on this section are substantive, others are more technical in nature.

While the concept of section 3.1 may be simple—the fund manager must refer conflict matters to its IRC for the IRC's recommendations before making decisions—we are concerned that it may be very difficult to apply to individual circumstances, since it is very broadly written and subsections (1) and (2) appear to introduce two different tests. We believe getting this section "right" is vitally important to the success of the new governance regime for Canadian mutual funds.

We are concerned that this all-important test is so broadly and ambiguously written that it will be open to different interpretations, so that fund managers and IRC members, alike, will be unclear of their respective responsibilities. Our concerns are heightened by statements in the Commentary that the Commentary does not list all circumstances when a manager may experience a conflict of interest—we note that the Commentary does not explain why this is so—and that the examples given in the Commentary are examples only and there may be other conflicts where the regulators would expect IRC input before a decision is made.

A fund manager must be able to practically assess whether it has reasonably complied with the Rule and similarly, an IRC must be able to assess whether it is carrying out all of its duties expected by the Rule. We are concerned about the potential for regulators, investors and even IRCs to "second guess" the fund manager and ask after the fact "you should have taken this matter to the IRC, why didn't you"? We are also concerned that an IRC has no guidance on what it should do, if anything, if the fund manager, in practice refers very little to it for its review and considerations.

In order to deal with the concerns we raise in our previous two paragraphs, we suggest that the Rule contain a requirement for a fund manager to refer to its IRC matters that fall within a defined list of conflict matters. In our view, this approach is consistent with the approach taken by the applicable CSA members in finalizing Multilateral Instrument 52-110 *Audit Committees*. In this latter rule, the audit committee is required to perform defined functions. Although we recognize the significant differences between corporate governance and mutual fund governance, we believe that this approach could be adapted to the mutual fund context.

We believe that many of the more significant matters—where the fund manager may have an interest in a matter that differs from the best interests of the mutual fund and therefore should be referred to the IRC—with a couple of exceptions, are those listed in the Commentary. We recommend that the Rule require a fund manager to refer a defined specific conflict, if it applies to its operations and the fund manager in fact is in a material conflict of interest situation, along with its proposed action or proposed policies to deal

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with the conflict to its IRC and then consider the recommendations of the IRC before taking any action in respect of that conflict.

As noted above, we do not agree with all of the conflict matters listed in the Commentary as we do not understand the potential for conflicts of interest within the meaning of the Rule [that is, the fund manager has an interest in the matter that is different from, or conflicts with, the best interest of the mutual fund] and recommend that each of these conflict matters be re-considered in light of the Rule's definition of conflicts. In particular, we don't understand why "marketing the mutual fund for sale through distributors, whether related to the manager or not, if the manager provides incentives to the distributors who sell the mutual fund and other mutual funds" is considered a conflict with respect to the mutual fund nor exactly what the CSA intend fund managers to take to the IRC in respect of such a matter.

We recommend that the listed potential conflict—"Favouring certain investors to obtain or maintain their investment in the mutual fund."—be further expanded to better describe the CSA's intentions. We assume this phrase is intended to capture the issues around "sticky assets" that have surfaced in the United States market timing investigations.

We wonder why personal trading policies of the fund manager are not referenced in the list of business conflicts?

We strongly recommend that section 3.1 be revised to clearly establish the responsibility of the fund manager to manage the mutual funds according to a defined standard of care. We are unclear about the CSA's intentions for dealing with the overlap between Part XXI (and the other applicable provincial statutes), particularly since the Uniform Securities Legislation published in December 2003 does not contain any part similar to Part XXI and there is no explanation about this omission in the USL materials (or in the 81-107 materials). We believe that the current standard of care contained in section 116 of the Ontario Act (and other provincial statutes) should be moved to the beginning of Part 3. We believe this addition would more clearly establish the manager's responsibilities and accountabilities and would provide a better context for readers of the Rule. That is, the Rule reinforces this responsibility and accountability and requires the manager to take into account judgment from independent review committees in making a decision when the fund manager is in a material conflict of interest situation.

We also recommend that the CSA provide clear Commentary about any decision to exempt mutual funds and their managers from the provisions of Part XXI of the Ontario Act (and other applicable provincial statutes) to the extent they comply with the Rule, assuming that the CSA in fact make this decision (which we believe would be appropriate). We believe that the Commentary should clarify that the fact that the prohibitions currently provided for in this Part do not apply, should not be taken as meaning a fund manager can do something that is clearly not in the best interests of the mutual fund and contrary to the manager's standard of care. The Commentary should also explain why independent judgment is important in this area.

We find curious, the statement in the notice to the effect that the existing self-dealing and conflict of interest prohibitions (in securities regulation) would be repealed and the discretion of the IRC would effectively replace the prohibitions. In our view, the fund

manager cannot take actions that are contrary to its standard of care. The prohibitions and restrictions in Part XXI and NI 81-102 reinforced areas where the legislators and regulators felt the manager would generally be risking compliance with this standard of care. Since IRC recommendations are non-binding on fund managers—they are recommendations—"IRC discretion" cannot be taken as "replacing" the prohibitions. In our view, a reinforced duty on the fund manager to act in the best interests of the mutual funds, "replaces" the prohibitions. IRC input provides the fund manager with impartial, independent recommendations in circumstances where the fund manager cannot itself be objective in determining whether it is meeting this standard of care.

The Rule needs further clarity about how it applies to potential conflicts at a portfolio manager level. As you know, many fund managers contract with unrelated portfolio managers. Any conflicts of interest experienced by a portfolio manager will not be—and are not—conflicts of the manager of the mutual fund. We recommend that the Rule be amended to clarify this point and state either that (a) the fund manager has no obligation to monitor portfolio manager conflicts or (b) the fund manager must make reasonable inquiries of the portfolio managers of their policies and procedures to deal with any conflicts experienced by the portfolio manager (falling within the defined list). If (b) is considered the better approach, we believe that no IRC review should be required (or is necessary) if the portfolio manager is unrelated to the fund manager. Since an unrelated portfolio manager's conflicts are not conflicts of the fund manager, the fund manager has the necessary objectivity to ensure that the portfolio manager has appropriate policies and procedures in place to deal with its own conflicts of interest. The fund manager would monitor the portfolio manager's processes to deal with conflicts in the same way as it monitors the services provided to the funds by the portfolio manager.

If the CSA do not amend section 3.1 in the manner we suggest above (that is, to introduce a defined, but comprehensive, list of specific conflict referrals), we strongly recommend that subsections 3.1 (1) and (2) be combined into one simpler test. In our view, the test as written in subsection (1) is technically "backward" and does not achieve the CSA's objectives. Technically, a fund manager is only required to refer a matter to an IRC if a reasonable person would "question whether" the fund manager is in a conflict situation. According to the plain meaning of these words, this means the reference would occur only when there is uncertainty whether the fund manager is in a conflict situation. Clear conflict situations would not be referred, because a reasonable person would not question whether, but would definitively believe, the fund manager is in a conflict situation.

Further we do not understand what is intended by the phrase "in addition to any other conflict of interest that might be caught by the test in subsection (1)". As we noted above, we believe these subsections introduce very difficult uncertainties and would appear to be two separate tests, which we believe is not appropriate.

We submit the following as an example of a clearer and simpler test:

> If a reasonable person would consider that a manager or an entity related to the manager has a material interest in a matter related to its management of a mutual fund that is different from, or conflicts with, the best interests of the mutual fund, the manager must:

(i) determine what action in respect of the matter it proposes to take, having regard to its duties in section [X] [the standard of care];

(ii) refer the matter, along with its proposal determined under (a), to the mutual fund's independent review committee for its recommendations; and

(iii) consider the recommendations of the independent review committee before taking any action in such matter, having regard to its duties in section [X] [the standard of care].

We believe this test is not only simpler, but contains three essential elements that are missing from the Rule.

(a) The concept of materiality; that is, only material interests or conflicts should be referred.

(b) The practical necessity that the fund manager should first decide what it considers to be the best course of action to take in respect of the potential conflict matter.

(c) The manager's proposed and actual course of action must be determined in accordance with its standard of care. As a practical matter, an IRC will consider both the conflict and the manager's proposed course of action in making its recommendations on what it believes would be fair and reasonable result for the mutual fund.

We note that readers can reasonably interpret section 3.1 as requiring a fund manager to take each separate conflict situation every time the conflict arises to its IRC, as opposed to what we believe is the CSA's intention, namely that a fund manager can refer a conflict "generally" along with its proposed way to deal with the conflict to the IRC. So long as the fund manager then follows its policies on dealing with that type of conflict, the fund manager doesn't have to keep bringing each individual conflict to IRC's attention, although we expect that a fund manager and IRC would agree that the fund manager would regularly report, on an exception basis, on compliance with policies designed to deal with conflicts of interest. We suggest this approach be made clearly explicit in the Rule, perhaps by defining what is meant by the word "matter".

3.2 Changes to the mutual fund

As a threshold comment, we query whether there exists such an inherent conflict of interest between the manager and the fund arising with respect to some of the fund changes specified in section 3.2 that necessitate blanket and mandatory referral to the IRC. We urge the CSA to either re-consider the types of fund changes that should require IRC referral or introduce a test of materiality into section 3.2 before a particular fund change must be referred to the IRC. For example, we believe that changes in the fund auditor are adequately dealt with by other CSA regulation, so that the IRC review, 60 days notice requirement and the free switch right seem to constitute over-regulation of

a relatively uneventful matter (given the fiduciary duties of fund managers and the other CSA regulation of changes in auditor).

Further, 81-107 (as drafted) does not remove or address the regulatory approvals currently required under Part 5 of 81-102 for certain fundamental changes (eg., changes in the manager and fund mergers). In our view, IRC review of proposed changes (and, in relevant circumstances, the security holder vote) obviates the need for such regulatory approval.

We also point out the additional timelines imposed by 81-107 for purposes of implementing a section 3.2 change. For example, section 3.2 would require a proposed fund merger to be referred to the IRC for consideration and recommendations (which will take a period of time) and then the fund manager must give security holders an additional 60 days' notice to affected securityholders. Currently, the time frames for implementing a change (which are generally the time frames that apply to holding security holder meetings) are significantly shorter than the timelines we anticipate will apply under 81-107. We recommend that the CSA consider shortening the notice period in light of the IRC review.

We also note some specific technical issues with respect to section 3.2.

(a) 81-107 does not acknowledge the current exemptions contained in Part 5.3 of NI 81-102 with respect to increasing or introducing a fee or expense that is to be charged to a fund in the context of a "no-load" fund or where such fee or expense is charged by a party at arms-length to the fund.

(b) In terms of certain notice and approval considerations, NI 81-102 distinguishes between a "change in manager" and a "change in control" of a manager. In contrast, however, 81-107 only addresses the "change in manager" scenario. We are not clear whether the CSA intend for a "change in control" situation to be caught by the phrase "change in manager" in 81-107. In either case, we urge the CSA to adopt a more streamlined and practical approach to address "changes in control" of a manager, having regard to the logistical problems that have resulted from NI 81-102's current requirement to give securityholders 60 days' notice.

3.3 Inter-fund Trades

As a general comment, we view the proposed inter-fund trading rules in section 3.3 as overly prescriptive and inconsistent with both the manner in which the CSA are currently seeking to enhance fund governance through 81-107 and otherwise how investment products should be regulated in the future.

Furthermore, we are not convinced that prescriptive rules in this context will necessarily reduce conflicts of interest and, in some instances, are unnecessary. For example, given other securities regulation designed to achieve transparency of the securities held by portfolio managers (on an aggregate basis), we question the need for 81-107's market integrity and transparency rules concerning individual inter-fund trades. We view these rules, in particular, the rule requiring a transaction be "printed through a member

exchange or a user of the quotation and trade reporting system" under paragraph 3.3(c), as potentially negating a significant portion, if not all, of the benefit to securityholders from the reduced transaction costs that would otherwise result from inter-fund trading.

We note that Rule 17a-7 of the Rules promulgated under the *Investment Company Act of 1940* in the United States, which deals with inter-fund trading in the U.S. does not have a comparable "print to the page" requirement. We also submit that the "print to the page" requirement is at odds with the policy direction taken by the CSA in National Instrument 62-103 *The Early Warning System and Related Take-Over Bid and Insider Reporting Issues.* In NI 62-103, the CSA have clarified that a portfolio manager is required to aggregate the holdings of an issuer's securities by all of the managed accounts on which it exercises discretion. The policy rationale for this is that the portfolio manager, and not the clients of the portfolio manager, is the one who is directing the accumulation of a large position in an issuer, or is reducing that position. In an inter-fund trade, it is still the portfolio manager that is managing both accounts (the funds). The pricing at which the inter-fund trade is occurring is also already known to the marketplace and this transaction does not "move the market". Accordingly, we strongly encourage you to delete the "print to the page" requirement as being an unnecessary and costly requirement.

In our view, the potential for conflicts of interest in the area of inter-fund trading can be sufficiently addressed, without detailed and prescriptive rules, through appropriate disclosure and by IRC review of the manager's overall inter-fund trading policy consistent with the U.S. model.

In any event, the IRC's mandate should not, in our view, include the responsibility of reviewing proposed inter-fund trades on a trade-by-trade basis. Such an approach would effectively handcuff the investment decision-making process without any additional fund governance benefit accruing that would not otherwise arise as a result of IRC review of the general inter-fund trading policy.

3.4 Supporting Information

We agree that for matters referred to the IRC, the manager should (i) provide sufficient information, i.e., a description of the background facts and circumstances, proposed course or alternative courses of actions and further information when requested to do so, so that the IRC may properly carry out its responsibilities; and (ii) to otherwise make its senior officers who are knowledgeable about the matters at issue available to attend IRC meetings.

We have several practical concerns about the ability of the IRC to direct the manager to convene a special meeting of securityholders to consider and vote on "a matter".

(a) The Rule itself provides no parameters or controls on an IRC using this authority, although the Commentary indicates that the CSA anticipate this authority would be used in "unique circumstances", including where the IRC is "unable to resolve a difference of opinion with the manager". In our view, this is a very low threshold test having no real substantive element of materiality when considering the inherent expense and human resources necessary to convene and hold a securityholder meeting, not to

mention the very public nature of putting "differences of opinion" to a securityholder vote.

(b) Appropriate disclosure, as contemplated in section 2.11, will address most, if not all, "differences of opinion" scenarios in a more effective manner—that is, the IRC makes a recommendation, which is then not followed, in whole or in part by the fund manager because the fund manager does not believe the IRC's recommendations are in the best interests of the funds. Section 2.11 will then require the fund manager to publicly explain why it did not follow the recommendation.

(c) In circumstances where the IRC reasonably believes that the fund manager has breached or will breach its fiduciary standards, because, among other things, the fund manager has not followed the IRC's recommendations, we believe an IRC would more realistically follow different avenues, including resignation, public disclosure or contacting the applicable securities regulatory authorities.

(d) The IRC could use the power to convene a securityholder meeting, in a manner not contemplated by the CSA. For example, in a fund merger context, 81-107 requires (among other things) that securityholders be provided with 60 days' prior notice of the proposed fund merger. However, the IRC could convene a securityholder meeting to vote on the fund merger on the basis of a "difference of opinion" with the manager thereby elevating the fund merger to a matter of greater significance than currently contemplated by 81-107. We also foresee scenarios in which an IRC will decide to seek securityholder approval instead of making a recommendation, as contemplated in the Rule, notwithstanding the Rule's mechanics for making public any action of the fund manager that is contrary to a recommendation of the IRC.

(e) It is very unclear to us exactly what the securityholders would be voting on and we caution against including such a potentially damaging and sweeping power, particularly when such authority is not needed.

For these reasons, we recommend that the Rule be amended to delete this authority, as unnecessary, unrealistic and too open for misuse.

On a related point, the Commentary states that the IRC may need a "mechanism to contact securityholders". It is unclear, however, whether this mechanism means the channels and timelines contemplated in NI 54-101 *Communication with Beneficial Owners of Securities of a Reporting Issuer* and whether the IRC should have the authority to independently contact securityholders for purposes of sending information, convening a special meeting or for any other purpose.

Part 4 Exemptions

4.1 Exemptions
4.2 Revocations of exemptions, waivers or approvals

81-107 provides for the automatic revocation of exemptions, waivers or approvals that were effective before 81-107 comes into force and that "deal with the matters regulated by this Instrument". We strongly urge the CSA to consider their authority to make this rule and even if the individual members of the CSA conclude that they do have the authority to make the rule, to re-consider both the necessity for, and the breadth of the section.

We question the authority and the ability of the individual commissions to revoke individual orders granted by a securities commission or director exempting the recipient of that order from provisions in securities legislation or NI 81-102, without individual notice to the recipient and a hearing on the proposed revocation. Although a commission may make a rule providing for an exemption from requirements and may later revoke this rule, we submit that this power does not give the commissions the authority to revoke individual exemptions granted to applicants.

We also question the purpose for this section. 81-107 imposes new rules that must be complied with regardless of any previously granted exemption.

We are aware of the stream of exemptions granted from securities legislation on conditions related to review by an independent committee. These exemption orders expire under their terms pursuant to embedded sunset clauses. There is no need for any special rule "revoking" these orders. Indeed, we believe that fund managers that are presently relying on these orders will want to see them fall away once they have established an IRC and the IRC has agreed with the manager on a written charter. We recommend that the CSA consider this issue and provide guidance in the Commentary to the effect that a fund manager may in fact stop relying on the order and consider itself no longer subject to the conditions to the order, once it has established an IRC and the IRC and the manager have agreed on a written charter.

Apart from the orders described above, we do not see any need for such a broad revocation rule, which, even if a proper rule, would have the effect of revoking many years of exemption orders granted from conflict provisions, for example. We submit that it is most uncertain exactly which exemptions would be revoked by this section. For example, would only NI 81-102 exemption orders be revoked? What about NP39 exemptions? Orders granted by individual CSA members under applicable securities legislation? Exemptions granted under NI 81-105 or other applicable rules?

Part 5 Effective Date

5.1 Effective date

In the Request for Comment which accompanied 81-107, you indicated, "As a next phase of our work, we will continue to review mutual fund product regulation as a whole." We strongly urge the regulators not to treat the review of product regulation as a next step. In

our view, the review of product regulation is an essential piece of the new fund governance model and should not be viewed as a distinct step. A failure to deal with product regulation as a whole will not allow funds and fund managers to properly weigh the costs and benefits of 81-107 and will leave IRC members in serious doubt as to what role they are assuming in the future.

We believe 81-107 should have a clear transition provision for disclosure obligations in the simplified prospectus and annual information form. In particular, we do not believe that the appointment of the IRC, the adoption of a charter for the IRC etc. should automatically trigger an immediate need for an amendment to offering documents. Funds should be permitted to incorporate this disclosure as part of their annual renewal filings.

We also feel that the regulators need to consider and provide guidance to the industry on how to deal with issues that arise due to past disclosure in offering documents. For example, we suspect that most, if not all, public mutual fund offering documents state that securityholders will have the right to vote on any change of auditor. If 81-107 removes that requirement, how will existing securityholders be advised? We strongly urge the regulators to consider this issue and prescribe a mechanism that applies equally to all funds. This will provide certainty to mutual funds and their managers and ensure all Canadian public mutual fund investors are treated in the same manner.

Comments on British Columbia Securities Commission Notice 2004/03

Question 1-- The Proposed Rule gives some flexibility for how a fund establishes its independent review committee. However, the definition of independence in the Rule would prevent for example, a committee of the fund manager's board from being the independent review committee. Do you think we should provide more flexibility for the composition of the independent review committee? What benefits would there be to investors and fund managers if the Rule were more flexible? Would there be any inherent conflicts in the structure(s) you are proposing?

We believe that the regulators could, without changing the wording of section 2.4, provide more flexibility for the composition of the IRC if the related Commentary was revised so that persons holding the positions or in the relationships referred to in the Commentary (see paragraphs 2 and 4) are clearly presented as “examples” of persons that would often or in most circumstances be considered to be persons that are not independent and not as a definitive list of persons who will always not be independent. This concept is expressed in the first sentence of paragraph 4 of the Commentary but is not made clear in the balance of that paragraph. For IRC’s that include persons holding positions or in relationships of the type referred to in the Commentary, one approach would be to require the manager to disclose (for example, in the related annual information form) why the manager concluded that notwithstanding the relationship the person was independent.

Question 2 -- The Proposed Rule (see commentary 2 following s. 2.1 of the Rule) would allow fund complexes to, among other things, "share" an independent review committee with other fund complexes if it was appropriate for them. Is this practical? Would the members of an independent review committee be able to serve each fund complex impartially, given their responsibilities to the unitholders of each fund? What other

approaches could small fund complexes use to establish an independent review committee?

We believe that the sharing of an IRC is impractical and unlikely to be done by fund complexes due to the competitive nature of information and confidentiality concerns. We see no other alternatives but to have funds bear this additional governance burden (if the Rule is adopted). We note that the Rule may well create an additional barrier to entry, particularly for start-up or smaller fund complexes.

Question 3 -- The Proposed Rule has, as a foundation, that all fund complexes face conflicts of some sort - either business conflicts, or conflicts because of their relationships with other parties. Because of these conflicts, the rule would require all funds to have an independent review committee. Do you agree that we should impose this regime on all funds, or should we limit it to funds that wish to trade with, or invest in, related parties? What other mechanisms could we consider to ensure funds manage their general business conflicts properly and protect the interests of fund investors?

We have no comments on this question; however we understand that there would be some support for a structure that would impose these restrictions only on funds that require relief from established conflict of interest rules (for example, where the portfolio manager of a fund wishes to invest in securities of an issuer related to the funds).

Question 4 -- As a consequence of introducing a mandatory fund governance regime, we propose to remove the existing restrictions that prohibited funds from investing in related party securities, and engaging in other transactions with related parties. Could we relax these current restrictions without imposing a fund governance regime? What other mechanisms could we consider to manage related party conflicts and protect the interests of fund investors?

We believe that certain of the current restrictions could be relaxed, for example, to permit the purchase or sale of securities between related mutual funds at current market prices and otherwise on terms that are no less beneficial than terms generally available at the time of the transaction in arm's length transactions.

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We hope that our comments will be considered as constructive by the CSA. Please contact any of the lawyers in our National Investment Management Group if you wish to discuss our comments with us.

Yours truly,

"Borden Ladner Gervais LLP"

National Investment Management Group
Borden Ladner Gervais LLP