SIPA
SMALL INVESTOR PROTECTION ASSOCIATION

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Dear Mr. Stevenson and Ms. Beaudoin,

Subject : CSA National Instrument 81-106
Investment Fund Continuous Disclosure

The Small Investor Protection Association (SIPA) welcomes the opportunity to again comment on these proposals as regards open–ended mutual funds. We assume that the regulation will also apply to LSIF's and ETF's. As an assist to better understanding our position, we include as Appendix I our assessment of the intended audience for the disclosures. Since our last submission, we have become increasingly sensitive to fund disclosure and governance because of the well publicized corporate and mutual fund scandals and media Reports/investigations. The cited May 2003 COMPAS survey findings are reasonably consistent with other data regarding the poor quality of fund disclosure documents. See Kenmar Report MF#125 "The Mutual Fund Annual Report " May, 2003. The poor quality of fund disclosure documents has had a negative effect on mutual fund investors' financial health. This is due to the fact that they have bought unsuitable funds, unduly expensive funds, chronic underachieving funds, funds that limit liquidity that they were unaware of and/or funds wholly inconsistent with their risk profile, time horizon or needs. Timely, complete and accurate disclosure is an important and a necessary, but not sufficient, element for small investor protection.

We have reviewed proposed Rule NI81-106 (Investment fund Continuous Disclosure) and generally find it is a step in the right direction. Based on several years of investor

complaints with mutual fund reporting and disclosure we summarize some major points and concerns in relation to the proposals:

1. Independence of fund auditors from sponsor/parent firm - this is important as the fund investors are quite distinct from the investors in the parent Corporation (e.g. a bank) or the fund sponsor. This is not covered in the current Document but is a related and important issue relevant to disclosure.

2. The lack of specificity of commentary on performance and issues - what went right, what went wrong, what's being done directly related to the specific fund. Too often, general comments about the economy are made or some philosophy is presented with no real value to the reader. What unitholders deserve and are often denied is an honest discussion of results of whether the fund kept up with the market and peers and if not, why not. The new MDFP appears to be a step in the right direction, provided compliance is monitored and enforced by regulators.
Annual report performance tables should not only disclose pre-tax returns but compare them numerically and qualitatively to the applicable Total Return benchmark index (or indexes or blended index) returns over the performance measurement periods required by regulation. The ***applicable*** index is one which the fund has cited in the Prospectus or other public document as the benchmark against which it will compare itself. This is not the prevailing practice today as many firms do not cite the relevant benchmark returns making direct comparisons difficult for the ordinary investor. It would be preferable to include the worst and best 12-month periods rather than 6 months. This is consistent with independent reporting firm methodology and 6 months may be too low a data integration period. Most people think of returns based on a 12-month basis which is a more natural rhythm.

3. The role of a governance agency to approve financial statements prior to release does not appear to be covered. We assume that the IRC's contemplated in NI81-107 will not be implemented and that all the self-dealing investor-protecting prohibitions of existing regulations and other investor rights will be retained. We expect CEO certification of fund financial statements.

4. The unduly long delay in reporting results to unitholders is unacceptable - given the volatility of markets and the vast improvement in information technology, quarterly reporting seems well overdue. Semi-annual reporting could be acceptable if indeed the quality of reports is dramatically improved, material changes are promptly disclosed, meaningful fund governance rules are established and regulators increase their surveillance of fund operations/enforcement. We believe 90 days maximum post period end release is fair and easily and economically achieved /implemented.

5. There is a pressing need to clearly and plainly disclose brokerage commissions paid in $000's incurred, current and historical (5 years) and as a percentage of fund assets. These should be cited in tabular form along with the other financial metrics for ready visibility and comparison. Brokerage commissions can be a major cost for an investor, sometimes approximating or even exceeding the MER in costs .In essence, the sum of the MER plus brokerage commissions as a percentage of average assets is the "effective" MER. This is a very important measure to investors as the average Canadian

equity fund, for example, has a portfolio turnover approximating 100%. Disclosure would permit investors to calculate the "Commission MER". Currently, disclosure of these expenses is buried and obscured within a fund's Annual report (at the back in the NOTES section) and are reported in dollars, rather than as a percentage of assets. Thus, it is difficult for investors to gauge the true impact of commissions on their fund. It also explains why these fees are referred to as "hidden" by independent fund analysts.

6. The confusion caused by fund names that do not closely match holdings and the designated benchmark index - we suggest a minimum of 80 percent of assets be of the character suggested by the fund name. This is consistent with SEC regulations. We recognize that this is a NI81-102 issue but it is relevant to disclosure. This is in fact why it is so difficult to review this document because it is so closely linked to other regulations that are simultaneously undergoing change.

7. News Releases, email alerts and/or special mailings regarding fund acquisitions, name changes, changes in fee structure, auditor changes, regulatory investigations, manager changes and fund mergers to be advised within 5 days rather than the proposed 10 days maximum. In the case of a merger of funds there should be a definitive explicit comment as to the effect of the merger on fund fees (MER), manager change, risk profile or tax liability.

8. Disclosure of the overall health of the governance regime and ethics programs - quantitative metrics if possible

9. Formal disclosure and explanation of any litigation or material conflict-of-interest breaches

10. Mail to investors upon request and without charge the documented ethics policy and governance policy as well as proxy share voting policies & procedures and voting record of the fund

11. The mutual fund industry with 450^+ billion in assets has huge power to influence management and corporate performance/governance through the voting of their shares, yet many have failed to use this power. Because of this power, SIPA believes that shareholders have a right to know how their proxy shares are being voted and that the vote is consistent with the best, we underline best, interests of the fund. These new rules will make mutual funds transparent in their proxy policies and on their voting records. Timely disclosure via a Company Internet web-site of share voting/non-voting and rationale - no more than 30 days after the vote would not be unreasonable. A one-year delay is virtually useless to investors, advisors, regulators or independent fund analysts. The reasons for voting in a particular manner (or not voting) should also be disclosed, as this will reveal the underlying thinking of the fund manager. Again, an asterisk or other identifier should be used to highlight a potentially conflicted situation. e.g. if the fund sponsor or a related party manages a pension fund for a portfolio held stock or is promoting a financing.

12. We urge securities regulators to maintain the right of disapproval of proxy share policies. Are voting policies subject to regulatory disapproval? For instance, if a fund Sponsor simply stated its policy as "We do not intend to vote any of our proxy shares" or

“We intend to always vote in favor of management proposals", would regulators deem this to be outside the spirit of the regulation and reject it?

13. Mandatory mailing of Annual reports is a fundamental obligation of fund factories to already information- disadvantaged investors/unitholders. This should be the default option. Any NO RESPONSE should automatically require a mailing. (A controversial Dec.2002 OSC precedent-setting exemption ruling will allow mutual funds to stop automatic mailing of Annual Reports to already under-informed investors. The attitude of industry participants towards unitholders/Annual Reports is evident from the following: “Bates, a former chief executive in the fund industry agrees that much of the costs associated with the Annual reports were a waste in the first place because so few investors take the time to read through the document. There’s no question that for many recipients it tends to end up in the category of bulk mail. In many cases, it’s superfluous. For people that want it, they make a choice or you can get it tangibly online,” Source: Investment Executive Jan. 2003.). **Under no conditions should an investor’s choice of non-receipt of a disclosure document or the disclosure provided by NI81-106 limit his ability to file claims or withdraw /rescind from the fund.**

The Electronic delivery option if used should be strictly at the investors option and changeable at any time. Such delivery shall be via confirmed email not merely posting on a fund sponsor web site. However, we do agree that the filed documents should be available on the web-site.

14. Availability upon telephonic, written, FAX or email request of generally accepted fund volatility metrics-standard deviation, Beta and Sharpe ratio
Presentation of *after-tax* fund returns based on median Canadian tax rate could also be very useful. Ref.: Thorfinnson M. & Kiss J.,” The overlooked piranha”, Canadian Investment Review, Fall 1996. This is especially important for highly taxed Canadian investors. Such disclosure is already mandatory in the United States.

15. NOTES to annual financial statements should include the dollar amount and percentage of total brokerage commissions paid to related parties and affiliates for at least the current and prior year. See also item 6 above.

16. We recommend that *distribution expenses* be presented as an isolable line item cost. This is similar to the U.S. 12b -1 fee which is disclosed to American fund investors. The expense is significant for most funds and to subsume it in the management fee is wholly inappropriate, poor disclosure practice and unnecessary. It should be a separate line item on the Statement of Operations.
Currently, fund Annual Reports do not disclose senior management/officer compensation - it would not be inappropriate for investors to know that management didn’t receive a bonus or raise if the fund lost money or underperformed its benchmark. Investors should be told if portfolio managers are rewarded for returns or just beating peers. There is also no disclosure of fund holdings, if any, by senior management, the portfolio manager or trustees. The question is, why not?

17. Identification of portfolio manager name(s) and professional credentials and tenure with the fund. This is useful information to a potential investor.

18. Highlighting of conflicted portfolio holdings - conflict can arise because of work performed, such as corporate financing, by parent or affiliated companies over the previous two years. They should be identified by an asterisk or other suitable means. We would automatically include any holdings of the publicly traded stock of a parent and/or affiliated company or subsidiary. Increasing industry consolidation and the prospect of bank mergers makes this an issue of growing importance.

19. The names and contact coordinates (address, telephone number, fax number, email address) of the compliance officer, trustee/governance committee members and the lead external auditor should be provided with the financial statements.

20. Despite numerous requests from unitholders, mutual fund companies do not disclose what actions, *if any*, they are taking on behalf of unitholders via moral suasion, share voting, class actions or otherwise, to recover losses due to fraud that hurts unitholders returns. Specifically, massive losses were incurred by holdings of YBM Magnex Inc., Bre-X, and Nortel. In the case of Nortel for instance a bank owned fund may also provide banking, advisory and financing/IPO services for Nortel so it's easy to see a conflict-of-interest here. Canadian mutual funds have been extremely reluctant to step up to their fiduciary duties as shareholders. Canadians have lost billions of dollars via their mutual fund investments. This is an area where better Annual reports and material disclosures could provide useful information.

21. Valuation process descriptions are too vague, especially in the case of currency conversion practices in international and global funds. Details should also be provided on currency transactions such as any fees paid by the fund and if by a related party, whether or not transactions are converted singly or cumulatively and/or across funds and the frequency of such converting transactions. If Fair Value Pricing is used for foreign securities this should be disclosed in detail.

22. More detailed, visible and highlighted disclosure of trailer commissions actually paid out would be an assist to investors who still don't see the potential for conflicted advice and the ongoing impact of trailers on the MER of Canadian mutual funds. We also question the industry viewpoint that it is they who pay this commission to dealers and advisors. This is a specious argument as the management fee and other expenses charged to the mutual fund by the fund manager reduce the value of the units and are therefore in effect expenses that are borne by unitholders, albeit indirectly. We note parenthetically that this commission is paid even to those who do not provide advice and even to those, such as discount brokers, who are prohibited from providing advice.

23. SIPA supports the quarterly disclosure of portfolio holdings. This is important to investors and analysts to assess style, nature of portfolio changes, consistency with stated fund objectives and comfort level with the fund. The data can also be used in conjunction with other data to monitor fund activity and detect conflicts-of-interest. We urge the CSA to maintain the requirement to make available on request, and without charge, a summary of portfolio transactions. This allows investors, analysts, advisors and regulators to assess a fund's propensity to trade, the nature/value of portfolio

churning if any, as well as to assist in detecting any conflicts-of-interest, legal/regulatory non-compliances or breaches of fiduciary duty.

24. The meaning of the term “non-optional expenses” , as related to the calculation of MER, is not clear. We presume this means OPTIONAL EXPENSES such as wrap fees. A wrap account and associated fee is an investor option. We would require all non-optional expenses (i.e. fees over which the investor has no option but to pay) to be included in the MER.

25. We recommend the use of **Hold period** (in months) rather than portfolio turnover in % as a measure of trading activity. All of our feedback indicates that the Hold period in months is much more meaningful and understandable to small investors than turnover %. Investors can understand 12 months as a hold period rather than 100% and that’s what disclosure is really about. If disclosure is to be useful, it should be understandable. For numbers like 132%, investors are lost. We recognize that other jurisdictions utilize turnover % but would like to see the CSA take a leadership position in the interests of investor protection.

26. We recommend that all return or growth information for 5 years or more presented in graphical form be presented in semi-log scale. A linear scale does not provide the necessary insight or visibility.

As a basic concept for reporting, we recommend the use of plain language augmented by shading, placement, context, bolding, graphics and color to augment typed text. A good reference here would be DALBAR, “Disclosure in Mutual Fund Shareholder Reports”, May, 2003. Redundant, self-promoting or controversial information should be banned from disclosure documents e.g. Fund companies claim they pay sales commissions and trailer commissions, not the fund. We contend this is misleading since such expenses are in fact embedded in the management fee.

As a general rule we believe the AIF should disclose such matters as to whether or not a fund engages in “soft dollar “ transactions and under what conditions, pays for dealer shelf space, and the conditions under which insiders are allowed to trade in fund units. The amount(s) **in dollars** of any co-marketing initiatives with distributors and the names of the distributor(s) should also be disclosed in the AIF. We believe the disclosure of discount purchase breakpoints is best left to the Prospectus.

To the extent that advertising/brochures is disclosure, we would recommend tighter criteria for ads and enhanced monitoring. Consumer research shows that advertising can have a significant influence on a decision to buy a financial product perhaps even more than the prospectus or annual report Britain’s Financial Services Authority recently set up a hotline for the public and firms to blow the whistle on misleading financial product advertisements.

SIPA believe that Canadian investors should have direct unimpeded access to U.S. mutual funds and request that reciprocal recognition be given to SEC disclosure rules and regulations.

We have submitted our comments on a stand-alone basis. Should other proposed Rule changes occur such as those contemplated by NI81-107, our response here would be decidedly more cogent. If the self-dealing prohibitions of existing regulations are removed and conflicts of interest resolution left to a powerless IRC, significant additional continuous disclosure and appropriate amendments would be necessary to NI 81-106 in addition to other oversight.
Our submission to NI81-107 in particular took a dim view of how conflicts of interest are identified, resolved and disclosed. SIPA, along with many others, view proposed rule NI81-107 as a giant step backward in investor protection.

SIPA is also concerned about the ease which exemptions to regulations can be granted. Over the past 2 years, we have witnessed many exemptions that in our view reduced the safety of mutual fund investing, often without the timely knowledge of investors. It is costly and time-consuming for investors to research exemptions which remain masked from public view on often difficult to search websites. [Ref: C. Steven Brantford, "The Cost of Regulatory Exemptions", 19th Annual Conference of the European Association of Law and Economics Athens, Greece, September 19-20, 2002]. We request that exemptions from an investor protection regulation or rule should be treated with the same public disclosure and debate as the originating rule.

Finally, we stress again the critical need for routine regulatory monitoring/investigation and timely meaningful enforcement by the regulations with full public disclosure of findings, penalties and decisions. Rules without timely, meaningful and vigorous enforcement have no value and do not protect investors. For instance, will fund investors be compensated for the abusive trading permitted by several funds as revealed in the Globe and Mail ref Karen Howlett, "Select few reap unfair gain ", Monday, June 21, 2004 - Page B4

We hope this gives you a flavor of the issues as seen by mutual fund information users/investors. We would be glad to discuss this further with any OSC representatives.

Sincerely,

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APPENDIX I -The Audience

Annual Reports should be tailored to the literacy level of the reading audience. Literacy is the ability to read, write, calculate, speak, and understand, as well as sign (for the Deaf) and communicate in other forms of language, according to need. It is a continuum of these skills necessary for everyday life in the home, at work, in education and in the community. Twenty two percent of Canadian adults can use reading materials to carry out simple reading tasks only in familiar contexts with clearly laid out formats. They do not have the skills to cope with unfamiliar and more complex reading materials. The reading skills of 16% of Canadian adults are too limited to allow them to deal with the majority of written material encountered in everyday life. This percentage covers 5% of people whose abilities are at Level 1 and 2% report that they have no abilities in English or French, for a total of 7% at the lowest level of reading skills. Older Canadians, part-year workers, and workers from primary industries (forestry, agriculture, and fishing) are more likely to have reading problems than other Canadians. Five million adult Canadians have serious problems with reading, writing and math.
Reading and numeracy skills are closely related. The majority (62%) of Canadians have numeracy skills sufficient to handle the numerical tasks normally encountered in every day life. Twenty-four percent do not possess the necessary skills to meet most everyday numeracy requirements but can deal with familiar documents that require simple math skills such as addition and subtraction. The remaining 14 percent of Canadians cannot perform numerical operations consistently but can recognize numbers in isolation or in a short text.
A significant number of older Canadians have low literacy skills. Forty per cent of Canadians over 65 have not completed primary school compared to 4 per cent of Canadians between 26 and 35. Poor literacy skills may lower the quality of life for seniors and increase their health and safety risks. Regulators should also prescribe a minimum font size for all disclosures.

An April 1999 Angus Reid telephone poll performed for the Canadian Securities Administrators found that 41 percent of investors had a poor understanding of MER's and 29 percent had a poor understanding of mutual fund sales charges. A Summer 2002 multiple-choice financial literacy test sponsored by Cartier Partners Financial Group found that two-thirds of Canadians are financially illiterate.

Mutual funds typically, but by no means always, attract investors unwilling or unable to invest on their own, retirees/seniors, people of modest means or novice investors just starting out.
Annual Reports and other disclosure documents should be written to address these statistics but clearly cannot be aimed at the lowest common denominator. The consolidation of many different fund reports into an encyclopedic size document deters mutual fund investors from reading the document. Avoidance of industry jargon, forthright commentary and easy to locate properly placed information in context will greatly assist investors in understanding their mutual fund investments and decision-making.
Source on literacy: www.abc-canada.org (ABC CANADA Literacy Foundation is a national charity committed to promoting literacy to the general public and to the private sector).