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Dear CSA members:

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

AGF Funds Inc. ("AGFFI") is pleased to provide its comments with respect to NI 81-107 and looks forward to the implementation of a fair and effective investment fund governance rule reflective of the dual objectives of the *Securities Act* (Ontario)[1]:

1. to provide protection to investors from unfair, improper or fraudulent practices; and

2. to foster fair and efficient capital markets and confidence in capital markets.

AGFFI fully supports investment fund governance initiatives designed to meet, and in certain circumstances strike the appropriate balance between, these objectives. However, AGFFI has a number of outstanding concerns which we believe the CSA must address prior to the implementation of NI 81-107. These concerns include:

- Incursion of the independent review committee ("IRC") into the business judgment of the manager;

- Striking the appropriate balance between flexibility and predictability;

[1] *Securities Act* (Ontario) (the "Act"), s. 1.1. The securities legislation in the majority of CSA-member jurisdictions contain similar statements of purpose.

- Scope of liability of IRC members;
- The IRC within the corporate investment fund structure;
- Lack of a mechanism to resolve disputes between the manager and the IRC;
- Jurisdictional harmonization; and
- Costs of implementation and ongoing compliance.

Each of these concerns is addressed in further detail below.

Incursion of the independent review committee ("IRC") into the business judgment of the Manager

As currently drafted, NI 81-107 represents a substantial incursion into the business judgment of the manager. In particular, sections 5.2 and 5.3 of NI 81-107 require the IRC to approve or recommend proposed actions on the basis of considerations which are largely irrelevant to the question of whether the proposed action is in the best interests of the investment fund. These considerations include:

- whether the action is proposed by the manager free from any influence by an entity related to the manager and without taking into account any consideration relevant to an entity related to the manager[2];
- whether the action represents the business judgment of the manager uninfluenced by considerations other than the best interests of the investment fund[3]; and
- whether the action achieves a fair and reasonable result for the investment fund[4].

First, to the extent that these provisions hinge on whether the manager was influenced by interests other than those of the investment fund, NI 81-107 is premised on a faulty assumption – namely, that what is in the interests of the manager or an entity related to the manager will in all cases be detrimental to the investment fund. This is quite simply not the case. Furthermore, by focusing on the *existence* of a potential conflict, rather than on whether the proposed action is in the best interests of the investment fund, NI 81-107 will force the IRC to review a myriad of benign issues which, while they may manifest a potential conflict, do not expose the investment fund or securityholders to potentially deleterious effects. This state of affairs is likely to have the dual effect of increasing the costs associated with the IRC while simultaneously decreasing the IRC's effectiveness.

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[2] NI 81-107, section 5.2(2)(a).
[3] NI 81-107, section 5.2(2)(b).
[4] NI 81-107, sections 5.2(2)(d) and 5.3(1)(a).

Second, it is unrealistic for the CSA to suggest that an IRC will be in a position to make a meaningful determination as to whether an action achieves a fair and reasonable *result* for the investment fund. Neither the IRC nor the manager have a crystal ball with which to make such predictions. At best, the IRC may be able to determine whether the proposed action is, at the time the decision is made, in the best interests of the investment fund. Even then, however, this determination effectively makes the IRC a "back seat driver" to the manager in respect of business and operational issues. By mandating that the IRC take this consideration into account when making its determination, the CSA has dramatically, if unintentionally, expanded the scope of the IRC's mandate (and potential liability) on the one hand, while materially eroding the fundamental discretion of the manager to conduct its business and affairs in the best interests of the investment fund on the other. Furthermore, to the extent that NI 81-107 confers any power on the IRC over operational or business issues, the instrument serves to undermine the independence of IRC members.

Finally, the power of the IRC to approve and recommend proposed actions, especially when viewed in light of the corresponding obligation to disclose to securityholders all instances where the manager has elected not to observe such approval or recommendation, is in and of itself a powerful incursion into the business judgment of the manager which should not be underestimated. Viewed practically, it is reasonable to assume that managers will generally not take action in matters referred to the IRC without the IRC's approval or recommendation, as applicable. Accordingly, the insertion of the IRC into the decision-making processes of the manager manifests the potential to result in a significant power shift, giving the IRC the latent – but no less real – ability to dictate business and operational matters of the manager in a way likely not contemplated by the CSA in formulating NI 81-107. This concerns AGFFI for two reasons. First, it is reasonable to assume that the IRC will take an ultra-conservative approach to most, if not all, conflict matters given that on a risk-reward basis it is in the interests of the IRC and its members to do so. Indeed, in the absence of a mechanism which provides the manager with some degree of oversight, IRC members will be effectively unaccountable for decisions made with a view to limiting their potential exposure to liability rather than what is in the best interests of the investment fund. Second, unlike the professional managers employed by the manager to make business and operational decisions, IRC members will not necessarily have the requisite experience or qualifications to make such determinations. Notably, this will increase the likelihood that the IRC will look to external advisors to advise on many of the issues referred to its attention, further increasing the costs to securityholders associated with ongoing compliance.

AGFFI understands that the CSA has taken great pains to ensure that the mandate of the IRC is restricted to the provision of "sober second thought" on matters where there exists a potential conflict of interest. For the reasons set out above, we respectfully submit that this mandate should be further restricted to the determination of whether a proposed action which manifests a potential conflict of interest is in the best interests of the investment fund. Furthermore, AGFFI submits that in the majority of cases this determination should hinge on whether the proposed action will, or is likely to, result in any detriment to the investment fund or to securityholders.

Striking the appropriate balance between flexibility and predictability

One of the most difficult challenges faced by the CSA in drafting NI 81-107 is striking the appropriate balance between enshrining sufficient regulatory *flexibility* through the imposition of a "principle based" investment fund governance regime and ensuring the *predictability* necessary for managers to properly implement practices and ensure ongoing compliance with this regime. While the most recent incarnation of NI 81-107 has made great strides in this respect, there nevertheless still exist a number of areas where the instrument could be further refined, including:

- The definition of "conflict of interest matter". AGFFI recommends that the CSA create and oversee an investment fund industry sub-group with the mandate to advise the CSA respecting the specific types of "business" and "operational" conflicts which should be covered by NI 81-107. In its present form, NI 81-107 does not sufficiently describe the types of scenarios which the CSA envisions will be considered conflicts of interest falling into these categories. At a minimum, NI 81-107 should set out what the CSA considers to be the most common types of conflict of interest matters so as to ensure some degree of consistency in the application of the instrument across the investment funds industry. In addition, we respectfully submit that the definition should include some reference to the potential for economic detriment to the investment fund or securityholders, combined with a minimum economic materiality threshold. In this way, the IRC will not be burdened with making determinations on "theoretical" conflicts which do not manifest economic implications for investment funds and securityholders.

- The "reasonable person" standard. AGFFI recommends abandoning the "reasonable person" standard as the means to determine whether a conflict of interest exists for the purposes of NI 81-107. At the very least, the standard should be elevated to that of the "reasonable *manager*" to reflect the reality that the "reasonable *person*", with limited knowledge and understanding of the investment funds industry, would be incapable of making a meaningful determination in many cases.

- The mandate of the IRC. AGGFI recommends that the CSA revise NI 81-107 to more carefully circumscribe the scope of the IRC's mandate. As articulated above, this would involve substantially re-drafting sections 5.2 and 5.3 of the instrument to remove any language which might be interpreted as requiring the IRC to consider factors which are not relevant to the determination of whether a proposed action is in the best interests of the investment fund or securityholders. Furthermore, NI 81-107 should be amended to specifically acknowledge that the IRC shall not proactively

involve itself in the business and operations of the manager, that the IRC shall have no duty to seek out potential conflicts of interest and, finally, that it shall have no positive obligation to report any matter to a regulator except as expressly set out in the instrument. Similarly, references in the commentary to NI 81-107 encouraging the IRC to, for instance, hold meetings for the purpose of discussing matters outside the scope of their mandate should be removed from the proposed instrument.[5]

- The legal significance of the commentary. With so much of the substance of NI 81-107 contained in the commentary, AGFFI recommends that the CSA provide the investment fund industry with additional guidance respecting how CSA members view the commentary from a legal and enforcement perspective. Such guidance would be invaluable to the IRC in formulating their mandate and defining the scope of their obligations.

- The written charter. AGFFI recommends that section 3.4 of NI 81-107 be augmented to provide additional guidance respecting the types of matters to be addressed in the written charter, along with specific minimum standards with respect to the policies and procedures to be adopted.

- Standing instructions. AGFFI recommends that section 5.4 of NI 81-107 be amended to specifically acknowledge that any matter falling within the mandate of the IRC may be dealt with by way of a standing instruction.

It must be noted that the common theme underlying each of these recommendations is ensuring the consistent application of NI 81-107 across the investment fund industry by minimizing the potential for different managers and/or IRCs to interpret their obligations under the instrument in materially different ways. In the absence of such consistency, investors will be faced with the confusing task of attempting to differentiate between investment funds on the basis of their respective corporate governance practices. The likely result of any such exercise is the continuing erosion in investor confidence in the capital markets. Perhaps even more worrisome is the prospect that some managers, driven by market pressures to minimize costs, will adopt aggressive interpretations of their obligations under NI 81-107 which may expose securityholders to inappropriate (and potentially undisclosed) levels of risk.

Scope of liability of the IRC

As was the case with the January 9, 2004 draft of NI 81-107, the potential scope of liability of IRC members remains largely undefined. The resulting uncertainty will no doubt impact on the inability to secure adequate and appropriate insurance coverage for

[5] For example, see note 4 to section 4 of NI 81-107 which encourages IRC members to hold meetings for the purpose of discussing "sensitive issues of concern to them, including any concerns about the manager". To the extent that such concerns do not relate to potential conflicts of interest, there is no justification for the IRC to convene a meeting to discuss such issues, nor is there a justification for why the investment fund and securityholders should bear the costs of such meeting.

IRC members and render it exceedingly difficult for managers to attract willing and qualified individuals to serve as IRC members. In addition to the measures identified above, there are several other means by which the CSA could limit, or at the very least further define, the potential liability of IRC members. One such means would be the imposition of a cap on the liability of IRC members. A liability cap would make it demonstrably easier for insurers to quantify the potential risks of insuring IRCs and their members. This would translate into lower premiums and greater availability of insurance.

The IRC within the corporate fund structure

While the commentary to NI 81-107 suggests that the rule has been crafted so as to endow the manager with the flexibility to construct the IRC in the most practical and cost efficient manner, NI 81-107 does not recognize the existence of boards of corporate investment funds. In the interests of meaningful and cost effective investor protection and the recognition of existing oversight and governance rules already in existence, AGFFI believes the instrument should formally recognize the existence of boards of corporate investment funds and their committees. More specifically, we propose that in the case of corporate investment funds, NI 81-107 should expressly permit the IRC to be an existing or new committee of the board of directors. In AGFFI's view, this would translate into significant costs savings to securityholders by avoiding any functional duplication between the board (or board committee) and the IRC which might otherwise occur.

Lack of mechanism to resolve disputes between the Manager and the IRC

NI 81-107 as it is currently drafted does not contain a mechanism whereby the manager may intervene in the affairs of the IRC in order to protect the interests of the investment fund or securityholders. At a bare minimum, the manager should retain a degree of oversight of the IRC to ensure, amongst other things, that IRC members are sufficiently qualified, that potential conflicts of interest involving IRC members are identified and appropriately addressed and that the IRC is at all times acting within its mandate and reasonably with a view to the best interests of the investment fund. In the absence of such a mechanism, the potential for abuse is manifest, thus leaving both the manager, the investment fund and securityholders exposed to significant potential harm.

Jurisdictional Harmonization

As a necessary pre-condition to the implementation of NI 81-107, the CSA must reach a consensus amongst its members with a view to adopting a truly national instrument, with equal application across every CSA-member jurisdiction. At the present time at least one CSA member, The British Columbia Securities Commission, has expressed reservations respecting NI 81-107 as currently drafted. In the absence of jurisdictional harmonization, the CSA risks creating further confusion in the marketplace and exponentially increasing the already substantial potential costs of implementation and ongoing compliance.

Costs of implementation and ongoing compliance

The potential costs of implementation and ongoing compliance with NI 81-107 are substantial and must be weighed against the perceived benefits to be derived from this initiative. In this respect, AGFFI agrees with the following statement of the British Columbia Securities Commission[6]:

> "The British Columbia Securities Commission has been concerned throughout the development of [NI 81-107] that the cost-benefit analysis for the proposal was not done before the decision was made to propose imposition of a new governance rule. Our view is that the cost-benefit analysis should be an important factor in deciding whether to impose new regulatory requirements because the costs of those requirements are ultimately paid for by the investors whom the requirements are intended to protect."

Paramount amongst the factors to be considered in any such cost-benefit analysis should be the potentially significant expenses which investment funds will be required to incur in order to recruit, retain and insure qualified IRC members. In particular, to the extent that NI 81-107 leaves unanswered important questions respecting the potential scope of liability of IRC members, investment funds will likely be required to pay exorbitant insurance premiums and compensation in order to attract qualified candidates. Furthermore, as noted above, NI 81-107 as currently drafted does not sufficiently circumscribe the proposed mandate of the IRC. The resulting ambiguity will invariably lead to an increase in the number of meetings of the IRC and, as a result, increased costs to investment funds and securityholders. Given that each potential conflict referred to the IRC may require the retention of external advisors to assist the IRC in fulfilling its mandate, the potential expenses associated with the holding of each additional IRC meeting must not be underestimated.

Finally, we believe that it bears repeating that all of these costs will be borne by the investment funds themselves and, ultimately – as a result of the negative impact on fund performance precipitated by increased expenses – the very securityholders NI 81-107 is intended to protect. Accordingly, we ask the CSA to conduct a disciplined, systemic cost-benefit analysis prior to the implementation of NI 81-107 to ensure that its intended effects indeed outweigh the potential costs to investment funds and securityholders.

AGFFI would like to take this opportunity to recognize the many challenges faced by the CSA in formulating a proposal for investment fund governance which strikes a fair and effective balance between the objectives of investor protection and capital market efficiency. In pursuit of this balance, however, the CSA must recognize that the existing securities regulatory framework contains numerous mechanisms for timely, accurate and efficient disclosure of information to investors and restrictions on unfair practices which are designed to achieve many of the same objectives as NI 81-107. AGFFI respectfully submits that the proposed benefits of NI 81-107 as identified by the CSA will be dwarfed by the tangible costs of implementation and ongoing compliance and the intangible costs

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[6] BCN 2005/30 Request for Comment National Instrument 81-107 *Independent Review Committee for Investment Funds* and related amendments, published May 27, 2005.

generated by marketplace confusion. Accordingly, we ask that the CSA carefully weigh the costs and benefits of NI 81-107 in order to ensure that the instrument which is ultimately adopted is in keeping with the principles and objectives underlying Canadian securities laws and is truly in the best interests of investors.

Yours Truly,

AGF FUNDS INC.