IFIC
THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA
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September 16, 2005

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Registrar of Securities, Nunavut

c/o

Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8
Attn: John Stevenson, Secretary

- and –

Autorité des marchés financiers
Tour de la Bourse
800, square Victoria
C.P. 246, 22 étage
Montreal, Quebec H4Z 1G3
Attn: Anne-Marie Beaudoin, Directrice du secretariat

Dear Sirs/Mesdames:

Re: National Instrument 81-107 *Independent Review Committee for Investment Funds*

We are pleased to provide comments to the Canadian Securities Administrators ("CSA") on the version of proposed National Instrument 81-107 *Independent Review Committee for Investment Funds* published for public comment on May 27, 2005 ("NI 81-107").[1]

The Investment Funds Institute of Canada ("IFIC") is the Member association for the Canadian investment funds industry. Member firms include Canadian mutual fund managers administering over $544 billion in assets on behalf of Canadian investors, mutual fund distributors and related professional and supporting firms.

As the CSA is aware from our previous letters and many discussions with CSA staff, IFIC and its Members are largely supportive of the fund governance initiative proposed under NI 81-107 and its predecessor instruments: Concept Proposal 81-402 – Striking a New Balance: A Framework for regulating Mutual Funds and Their Managers ("CP 81-402")[2], and the previous version of NI 81-107.[3] The comments which follow are intended to make a positive contribution to the discourse surrounding this worthwhile initiative.

We are aware that not all of our Members agree on all of the points raised for discussion by the CSA in NI 81-107, or the additional points raised separately by the British Columbia Securities Commission ("BCSC"). In these submissions, we have tried to accommodate these divergent viewpoints where possible. We are also aware that a number of our Members have submitted or intend to submit individual comment letters to you.

I. General Comments:

(a) Cost/Benefit Analysis

In reviewing NI 81-107, we are sensitive to the CSA's desire to develop a fund governance regime that accommodates the perspectives of different constituencies within the industry and yet is seen to be sufficiently robust (both from a domestic and international perspective) by stakeholders outside of the industry, including investors viz a regime that provides meaningful investor protection but avoids increasing costs to the extent that investment funds will become cost prohibitive to the average investor, thus hampering industry competition and innovation, and effectively reducing investment options for Canadians.

The questions raised by the BCSC with respect to the cost/benefit analysis of the proposed NI 81-107 regime restate concerns that our Members have expressed from the outset of the CSA's fund governance initiative. The BCSC notes that the CSA decided to

[1] At (2005) 28 OSCB (Supp-2).
[2] Published for comment on March 1, 2002.
[3] Published for comment on January 9, 2004 at (2004) 27 OSCB 526.

institute some manner of fund governance *prior* to engaging in any comprehensive cost/benefit analysis, effectively assuming the need for (and benefits arising from) some form of mandatory fund governance regime for all fund managers in Canada, then making a determination as to the reasonableness of costs based on this presumed need.

While many of our Members have come to accept and support the CSA's starting assumption, others are of the view that this assumption appears to prevent the CSA from making an objective evaluation of the true costs of the current proposal, and also from giving meaningful consideration to alternatives. In our view, there has yet to be a true reckoning of the costs that will accrue to fund managers and, ultimately to investors as a result of the imposition of the fund governance regime proposed in NI 81-107. Such a reckoning is, we submit, a necessary precursor to informed analysis of any new regulatory initiative.[4]

Consideration of alternatives is discussed in more detail below.

(b) Scope of NI 81-107

The need for the CSA to develop a fund governance proposal that is a proportionate response to empirically verified gaps in our existing regulatory framework has been an underlying theme of IFIC and industry submissions on both CP 81-402 and the previous version of NI 81-107.

We are particularly concerned that the most recent version of NI 81-107 may reflect a movement further away from a regime developed in response to demonstrated gaps in the existing regulatory framework or based on a realistic appraisal of the actual patterns of behaviour of Canadian mutual fund investors.

[4] We note that the Chamber of Commerce of the United States ("COC") recently petitioned the U.S. Court of Appeals (District of Columbia Circuit) for review of a corporate governance Rule promulgated by the Securities and Exchange Commission ("SEC") that would require an investment company, prior to engaging in certain transactions otherwise prohibited by the Investment Companies Act of 1940 ("ICA"), to have a board with no less than 75% independent directors and an independent chairman. The Court determined that the SEC failed to adequately consider the cost consequences and alternatives of its proposed Rule and granted the COC's petition in part by sending the Rule back to the SEC for further consideration. With respect to the SEC's inadequate consideration of costs, the Court noted that:

"…uncertainty may limit what the Commission can do, but it does not excuse the Commission from its statutory obligation to do what it can to apprise itself – and hence the public and the Congress – of the economic consequences of a proposed regulation before it decides whether to adopt the measure." – Chamber of Commerce of the United States of America (Petitioner) v. Securities & Exchange Commission (Respondent) – U.S. Court of Appeals for the District of Columbia Circuit (No. 04-1300), at 16-17.

To this end, we note that CP 81-402 proposed a fund governance regime as only one of five elements in a comprehensive regulatory scheme designed to ensure that the Canadian fund industry remains on a par with investor expectations and developing international standards. While industry input was instrumental in the CSA's decision to proceed with the fund governance portion of this proposed regime first, it is important to resist the urge to see the Independent Review Committee ("IRC") to be established by funds pursuant to NI 81-107 as a complete substitute for all of the other regulatory reforms proposed under CP 81-402. Similarly, it is appropriate to consider alternatives including other "in-progress" or recently instituted reforms when defining the role that an IRC will be expected to play.[5]

The BCSC, itself a CSA member, continues to seek to more fully canvass alternatives to certain aspects of NI 81-107. Our Members believe that many of the questions raised by the BCSC give rise to threshold issues that must be addressed to determine the appropriate scope of independent oversight of mutual fund managers in Canada. Accordingly, we are of the view that the CSA is obligated to participate actively in the discussion and resolution of these issues. The mere presence of a mandatory IRC, even one that is given significant authority and aggressive oversight responsibilities, is not a complete panacea. Moreover, the efficacy of such a body is likely to be even less in a regime such as ours, that does not have significant regulatory gaps.

The Investment Management Association ("IMA")[6] in its February, 2005 paper to the UK's Financial Services Authority ("FSA") canvassed governance practices in different jurisdictions and made recommendations with respect to possible changes to the governance of collective investment schemes ("CIS") in the UK. The IMA, in canvassing governance requirements in the U.S. noted as follows:

> "Elsewhere, the recent late trading and market timing scandal in the United States has underlined the importance of several matters that this paper seeks to address.

[5] We note that this issue was also raised by the U.S. Chamber of Commerce and, with respect to the SEC's consideration of alternatives the Court stated:

> "To be sure, the Commission is not required to consider "every alternative conceivable by the mind of man…regardless of how uncommon or unknown that alternative" may be…Here, however, two dissenting Commissioners raised as an alternative to prescription, reliance upon disclosure…a familiar tool in the Commission's toolkit – and several commenters suggested that the Commission should leave the choice of chairman to market forces, making it hard to see how that particular policy alternative was either "uncommon or unknown"… [T]hat the Congress required more than disclosure with respect to some matters governed by the ICA does not mean it deemed disclosure insufficient with respect to all such matters…In sum, the disclosure alternative was neither frivolous nor out of bounds and the Commission therefore had an obligation to consider it…[With respect to the consideration of alternatives] The Commission…is charged by the Congress with bringing its expertise and best judgment to bear upon that issue." , *Ibid*.,at 17 – 19.

[6] The Trade Association for collective investment schemes and the investment management industry in the UK.

> The US regulatory authorities have clearly concluded that there were sufficiently serious flaws in their system of governance for them to institute sweeping changes. Indeed the resultant regulatory programme in the US probably represents the single largest overhaul of the US mutual fund regulatory regime since its inception in 1940.
>
> The *Working Party* has however noted, that a very small number of mutual fund managers have been identified as at fault: the vast majority by number and assets under management, have seen no regulatory or legal enforcement action. Its conclusion is that with the right people and right procedures in place, the previous governance system demonstrably worked.
>
> Indeed it can be argued that some areas of corporate governance in other jurisdictions, notably independent directors, failed to prevent the behaviours complained of, or at least there does not appear to be any evidence that their existence acted as a deterrent to those behaviours.[7]
>
> [Specifically,] The existence of a majority of independent directors on fund boards in the US had not seemed to impair the growth of practices such as late trading and market timing, reinforcing its view that the focus should be on qualitative rather than quantitative or simple "tick box" approaches to governance".[8]

We ask the CSA to ensure that the final form of proposed NI 81-107 is a proportionate regulatory response that reflects recognition of the fact that the introduction of independent oversight of fund managers in Canada will occur within the context of a regulatory framework that is already extremely stringent and by no means fundamentally flawed.

(c) National Application

As noted, the BCSC has raised significant questions around the implementation of the regime proposed in NI 81-107. Should the BCSC ultimately choose to adopt a different approach to fund governance, the concerns noted above will be exacerbated by the added inefficiency of having to comply with standards that are not uniform across Canada.

We urge the CSA on behalf of both investors and our Members to give serious consideration to the concerns of the BCSC and to come to a final version of proposed NI 81-107 that can be adopted uniformly across all CSA jurisdictions.

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[7] IMA Submission to FSA (February, 2005) "Review of the Governance Arrangements of United Kingdom Authorised Collective Investment Schemes" (p.8).
[8] Ibid at pp. 19-20.

II. Specific Comments:

Comments raised by our Members on specific aspects of NI 81-107 follow:

(a) Definition of "Conflict of Interest Matter"

The definition of "conflict of interest matter", as set out in section 1.3, is overbroad and should be amended to include a materiality test. This is discussed further under paras. (j) and (k) below.

The issue is not whether the interest of a manager "may conflict" with its ability to act in good faith and in the best interests of the investment fund, but rather whether a reasonable person would consider the manager to have a material interest that could influence the manager to take a particular action that is different from the action it would take solely considering the best interests of the mutual fund.

(b) Definition of "Entity Related to the Manager"

Commentary 1 to section 1.4, states that the CSA consider the portfolio manager or portfolio adviser (or sub-adviser) of the investment fund to be an agent for the purposes of section 1.4(b).

Any conflicts of interest experienced by a third party portfolio manager are not conflicts of the manager of the mutual fund and should not be treated as such. Our Members therefore believe that it is inappropriate to require a fund manager to be aware of, and refer to the IRC, any conflicts experienced at a third party portfolio manager level.

Accordingly, we recommend that proposed NI 81-107 be amended to explicitly state that the fund manager has no obligation to monitor third party portfolio manager conflicts.

In the alternative, we believe that the role of the IRC should be limited to: (i) giving standing approval to the fund manager's policies and procedures with respect to the outsourcing of the management function to third party portfolio managers; and (ii) receiving reports from the fund manager on an exception basis. In this alternative, we ask that the CSA amend the Commentary to this section to explicitly indicate that the obligations of a fund manager pursuant to this section will be discharged if the fund manager obtains such standing approval of its policies and procedures from the IRC.

(c) Definition of "Manager"

Commentary 1 to section 1.7 states: The term "manager" is intended to include instances where a corporate board or limited partnership of an investment fund acts in the capacity of "manager"/decision-maker, or when the circumstances of the investment fund merit the designation of more than one person or company as "manager".

Our Members are of the view that the Commentary to section 1.7 needs to be clarified. Does the CSA mean to suggest that an internally managed investment fund that does not have a manager (an LSIF or a limited partnership for example) must still set up a separate group of people to form an IRC? What requirements would the Commentary to this section result in for an investment fund that is managed by its own board of directors who already carry out governance functions on behalf of the fund?

With respect to the words "or when the circumstances of the investment fund merit the designation of more than one person or company as "manager", what are the circumstances referred to in the Commentary in which an investment fund might have more than one manager? Our Members are concerned that the inclusion of this language could result in a third party portfolio manager, trustee or administrator being caught under this definition.

We ask that the CSA remove these words from the Commentary as the designation of more than one person or company as "manager" would result in uncertainty and confusion for all parties involved with the investment fund including investors, the two (or more) managers, the portfolio manager, other service providers and the securities regulatory authorities.

(d) Manager to Maintain Records

Section 2.3(a) would require a manager to maintain a record of any activity that is subject to the review of the independent review committee, including minutes of its meetings. This requirement is unnecessarily prescriptive and we ask that the CSA adopt a materiality/*de minimis* test with respect to this subsection so as to ensure that the requirement to take minutes applies only with respect to meetings where significant issues are discussed.

(e) Mandatory Imposition of IRC's on Smaller Fund Managers

Further to our discussion of the need for a fulsome cost/benefit analysis above, a number of our Members, particularly smaller fund managers with fewer business conflicts, continue to believe that the CSA have significantly underestimated the costs of an IRC to smaller fund managers. These Members are concerned that the direct and indirect costs of an IRC will create economic pressures that will result in a consolidation of the industry and act as a barrier to entry for new market participants, thereby creating an environment

in which competition and innovation in our industry are compromised to the detriment of Canadian investors.

In the view of this constituency, requiring fund managers to have an IRC only if they wish to engage in transactions covered by the prohibitions in legislation similar to Part 21 of the *Securities Act* (Ontario), or Part 4 of NI 81-102 – *Mutual Funds* ("NI 81-102") would allow for a more efficient deployment of resources and would increase the value of IRC review to investors as fund managers would have the flexibility of charging the costs of an IRC to an investment fund only where there was proportionate benefit to investors.

(f) Investment Funds Sharing IRC's

Commentary 2 to section 3.1 of proposed NI 81-107 indicates that the sharing of an IRC among several investment fund managers may provide smaller funds with some cost relief. It is apparent that for profit firms are being created for the sole purpose of providing shared IRCs to smaller fund managers. Commentary 1 to section 3.4 indicates that the CSA expects that an IRC will establish a separate charter for each fund complex that it oversees. In addition, individual fund managers must develop their own policies and procedures tailored to the needs of their specific operations. We are concerned that the development of such firms, driven to maximize profit through economies of scale, will result in a prescriptive, "cookie-cutter" approach which will ignore the specific needs of individual funds or fund families. We also have concerns about the quality of IRC members that these organizations will provide.

As noted in our April 8, 2004 submission, we also believe that unrelated fund managers will find it highly undesirable to share an IRC due to issues of confidentiality. Accordingly, as a practical matter, we do not see smaller fund managers realizing significant cost savings through the sharing of IRCs.

(g) IRC Authority

Section 3.9(1)(e) states that an IRC has authority to "communicate directly with the securities regulatory authority or regulator with respect to any matter."

Commentary 3 to section 3.9 states that "Paragraph (1)(e) is intended to encourage the members of the IRC to inform the securities regulatory authority or regulator of any concerns that the IRC is not otherwise required to report. For example, the IRC may be concerned if very few matters have been referred by the manager for review, or it may have found, or have reasonable grounds to suspect, a breach of securities legislation has occurred."

Our Members are of the view that the authority conferred by section 3.9(1)(e) is much too broad given the fund manager's existing fiduciary duty and ultimate responsibility for decisions made on behalf of the investment fund. Our Members also believe that this open-ended authority is inconsistent with the CSA's stated objective of emphasizing the limited scope of the IRC's mandate, so as to thereby limit the IRC's corresponding fiduciary duty and duty of care. We remind the CSA that the opinion of external counsel[9], which states that an IRC Member's exposure to liability would be limited when compared with the exposure to liability of a corporate director, is based upon the more limited mandate of IRC members.

We are of the view that section 3.9(1)(e) is inconsistent with the limited mandate of the IRC and should be removed. If the CSA is not amenable to this suggestion, we believe that it is necessary to narrow the scope of this section by removing the words "any matter" and instead providing a list of material issues with respect to which it would be appropriate for the IRC (having regard to its limited mandate) to communicate directly with the regulator.

(h) Functions of IRC

Subsection 4.1(3) requires that the IRC deliberate and decide on a matter referred to in subsection (1) in the absence of the manager or any entity related to the manager.

We ask that the CSA amend this subsection to make this requirement permissive, as it would be more practical to allow the IRC to assess the relative sensitivity of individual matters put before it and then to make a determination on the basis of its discretion as to when deliberation in the absence of the manager or any entity related to the manager would be desirable.

(i) Reporting to securities regulatory authority

Section 4.5 of proposed NI 81-107 requires the IRC to notify, in writing, the securities regulatory authority or regulator if the IRC becomes aware of an instance where the manager proceeded to act in a conflict of interest matter under subsection 5.2(1) but did not meet a condition imposed by securities legislation (including proposed NI 81-107) or the IRC in its approval of the matter.

We submit that a requirement to report "an instance" where the manager acted without meeting a condition imposed by securities legislation or IRC approval, is overbroad and and inconsistent with the limited IRC authority and liability contemplated by the CSA.

[9] May 2, 2005 Memorandum of Carol Hansell (Davies, Ward, Phillips & Vineburg LLP) to Susan Silma and Rhonda Goldburg.

This requirement will result in the IRC reporting any and all matters, without regard to materiality or whether the matter is a technical breach that nonetheless continues to meet the spirit of securities legislation or IRC requirements.

We strongly encourage the CSA to adopt a materiality requirement and allow the IRC to use its discretion as to what it will report to the securities regulatory authorities.

(j) Requirement for Manager to Refer All Conflict of Interest Matters to IRC

Commentary 1 to section 5.1 states that "a manager may not be able to objectively determine whether it is acting in the best interests of the investment fund when it has a conflict of interest. This section requires managers to refer all conflict of interest matters – not just those subject to prohibitions or restrictions under securities legislation - to the IRC so that an independent perspective can be brought to bear on the manager's proposed action in a conflict of interest matter."

The requirement for the IRC to review every conflict of interest matter is duplicative of the review that the fund manager is qualified and already obligated to perform under sub-section 116(1) of the *Securities Act* (Ontario) and section 2.1 of the Rule. This requirement will not add value and has significant potential to allow for micro-management of the affairs of the fund manager and the investment fund by the IRC, thereby resulting in an inappropriate extension of the IRC's authority beyond the limited mandate contemplated by the CSA. Accordingly, our Members are of the view that it is necessary for conflicts subject to IRC review to be narrowed. We submit that the definition of "conflict of interest matter" must be clarified and made subject to a materiality test to ensure that IRC review results in added value and recognizes the fund manager's existing duties to the fund.

(k) When the Manager Should Refer Conflict of Interest Matters to the IRC

With respect to when the manager must refer conflict of interest matters to the IRC, (section 5.1) and, subject to our comments in (j) above, we suggest that the Rule should oblige the manager to refer a matter relating to its management of a fund to the IRC where a manager or related entity has a *material* interest in the matter which is different from, or conflicts with, the best interests of the mutual fund.

This incorporates three important elements into the Rule *viz*

(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 and

(c) the manager's proposed and actual course of action must be determined in accordance with its standard of care.

(l) Transition

While the CSA have provided a transitional period for existing funds, new funds (including new funds in existing fund complexes) will not be permitted to launch until they are compliant with the requirements of proposed NI 81-107. New funds may confront the same issues as existing funds in meeting the requirements of proposed NI 81-107. We submit that it would be equitable for the CSA to treat new funds consistently with existing funds and extend the transitional relief set out in s. 8.2 to new funds for a reasonable start-up period.

(m) Appendix "C"

Subsection 4(c) of Appendix "C" amends Item 15 of Form 81-101F2 *Contents of annual Information Form* ("Form 81-101F2") by deleting subsection (2) and substituting the following:

"Describe any arrangements, including the amounts paid, the name of the individual and any expenses reimbursed by the mutual fund to the individual, under which compensation was paid or payable by the mutual fund during the most recently completed financial year of the mutual fund, for the services of directors of the mutual fund, members of an independent board of governors or advisory board of the mutual fund and members of the independent review committee of the mutual fund".

Our Members believe that there is no added value to investors in breaking out and disclosing the items and amounts paid on an individual basis. It would be sufficient, in the view of our Members, to disclose in aggregate the amounts paid for each of: the services of directors of the mutual fund, members of an independent board of governors or advisory board of the mutual fund and members of the mutual fund's IRC.

(n) Appendix "D"

<u>Changes to Section 4.1 of NI 81-102</u>

Proposed new subsection (4) of Section 4.1 of NI 81-102 contemplates that a mutual fund will be able to purchase securities from a related underwriter subject to a number of conditions. One of the conditions for an investment in a class of equity securities of an issuer is that the investment be made on a stock exchange on which the class of equity securities are listed and traded.

While a purchase of equity securities during the subsequent 60-day period can be made through a stock exchange, a purchase made in an underwritten offering cannot be made through a stock exchange. The existing exemption orders relating to purchases from related underwriters are consistent with these facts. We ask that the CSA address this issue by making the appropriate amendments to proposed new subsection (4).

Changes to Part 3 of Companion Policy 81-102CP

Proposed new subsection 3.8(2) reads, in relevant part, as follows:

"In providing its approval under paragraph 4.2(3)(a), the CSA expects the independent review committee to have satisfied itself that the price of the security is fair. This may be achieved by the independent review committee by considering the price of the security if listed by CanPx or TRACE, for example. Or, the independent review committee may satisfy itself by obtaining at least one quote from an independent, arm's-length purchaser or seller, immediately before the purchase or sale."

Our Members are of the view that it is inappropriate to provide the IRC with the option to satisfy itself by obtaining at least one price quote from an independent, arm's-length purchaser or seller, immediately before the purchase or sale. This process may consume too much time in the case of standing transactions and is inappropriate as micro-management of the affairs of the fund manager. A fund manager's policies and procedures would be expected to address the issue of obtaining price quotes in connection with the purchase or sale of securities and the manager should be able to rely exclusively on standing IRC approval of such policies and procedures.

III. In Conclusion

Thank you again for the opportunity to provide you with the comments of our Members on this important initiative. Please contact the undersigned, John W. Murray - Vice-President, Regulation & Corporate Affairs at (416) 363-2150 x 225 / jmurray@ific.ca or Aamir Mirza – Legal Counsel at (416) 363-2150 x 295 / amirza@ific.ca should you have any questions or wish to discuss these submissions.

Yours truly,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: **Original signed by Thomas A. Hockin**

Hon. Thomas A. Hockin
President & Chief Executive Officer