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September 27, 2005

BY ELECTRONIC MAIL

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

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario
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Anne-Marie Beaudoin, Directrice du secretariat
Autorité des marchés financiers
800 square Victoria, Tour de la Bourse
C.P. Box 246, 22 etage
Montreal, Quebec
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Dear Sirs/Mesdames:

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

We are pleased to provide our comments to the members of the Canadian Securities Administrators (CSA) on proposed National Instrument 81-107 *Independent Review Committee for Investment Funds* and its accompanying Companion Policy (collectively, NI 81-107). **We are also commenting on the proposed amendments to existing national instruments published by the CSA at the same time as NI 81-107. These latter comments are noted at the end of this letter and we ask that this letter be considered as a comment letter on each of those proposed amendments.**

Our comments on NI 81-107 and the related amendments to existing instruments have been compiled with input from the lawyers in BLG's Investment Management Practice Group and therefore reflect our collective views. Our comments do not necessarily reflect the opinions of, or feedback from, our investment management clients. We know that many of our clients have expressed their views directly to the CSA either as part of the

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submission of The Investment Funds Institute of Canada or under a separate comment letter.

Since the release of the first version of NI 81-107 in January 2004, we have worked with a number of fund companies considering enhancing or introducing forms of independent oversight. Those fund companies have chosen to introduce a governance agency or enhance existing governance in ways that are consistent with the published versions of proposed NI 81-107. This has given us a unique perspective on how NI 81-107 will operate in practice and has allowed us, with our clients, to have first-hand experience of the degree of effort required to set up a form of governance consistent with NI 81-107 and also to see how, as a practical matter, a fund company can work with an independent review committee and vice versa.

Given our role as lawyers for our investment fund clients and our experience in working with clients on fund governance matters, we have concentrated on providing you with comments on matters that we believe, from a practical or technical perspective, need revision assuming the CSA moves forward with NI 81-107. This is the approach we took in providing the CSA comments on the January 2004 version of NI 81-107 and we were pleased to see certain of our comments reflected in the new draft.

Overall we believe the current draft of NI 81-107 continues the proper focus for investment fund governance—namely of instituting a degree of independent oversight over a fund manager's methods of managing conflicts of interest. We believe that independent oversight will enhance public confidence for investing in mutual funds and other investment funds and may assist fund managers in continuing to meet their fiduciary standard of care. However, we urge the CSA to continue to assess how this new regulation fits with existing regulation and to ensure that the overall burden of regulation of investment funds is considered as a whole when that new regulation is proposed. The latest CSA notice accompanying NI 81-107 did not address whether the CSA would be continuing to review the existing regulation in light of this new element.[1] This leads us to believe that NI 81-107 will be an "add-on" to existing regulation instead of one pillar of a comprehensive and cohesive set of regulation.

Principal Comments on NI 81-107

1. ***We agree in principle with the expanded scope of NI 81-107 to include public investment funds that are not mutual funds, but urge careful consideration of the different types of investment funds.*** NI 81-107 is now proposed to apply to all public investment funds. While we support this in principle, we believe NI 81-107 needs revision to take account of the different types of investment funds. NI 81-107 should not duplicate or require unnecessary revision to existing independent governance standards that are in place today for those investment funds. Some investment funds should be completely exempted from NI 81-107 (for example, single purpose funds and split-share corporations where no

[1] We note that the amendments to the existing national instruments and the implementing rule in certain jurisdictions (such as Ontario) do modify existing regulation to account for NI 81-107. In our view, these modifications are necessary to ensure that NI 81-107 can operate properly, but do not amount to the complete review of existing regulation that we believe is necessary.

decisions of the nature contemplated in NI 81-107 have to be made). We point out some practical examples of necessary modifications later in this comment letter.

2. ***We believe that the definition of "conflicts of interest" must be clear, accurate and legally enforceable.*** The definition of conflicts of interest is central to NI 81-107. It needs to be comprehensive, yet understandable to the staff of a fund company and to the individuals who are members of an independent review committee (IRC). We provided extensive commentary in our letter of April 16, 2004 about the need for clarity and certainty around this concept and suggested several revisions to section 3.1 of the January 2004 version of NI 81-107. The CSA chose not to move to the approach we recommended, that is, define in NI 81-107 specific conflicts that must be taken to an IRC, but we continue to believe this approach would achieve certainty, clarity and potentially industry-wide buy-in to the new rules. We urge the CSA to re-consider the comments we made on section 3.1 in our April 16, 2004 comment letter that we have reproduced below. At the very least, the definition of "conflict of interest matter" must be modified and we recommend that examples of common conflicts of interest should be provided in Commentary to illustrate the meaning of the rule. The rules as drafted continue to be too broad and ambiguous.

3. ***NI 81-107 contains overly complex procedures and detailed rules.*** In contrast to the first version of NI 81-107, this version of NI 81-107 is complex and contains many detailed rules. We are concerned about the number of reports, communications and disclosures that must be made, filed with regulators or made available to investors by either the fund manager or the IRC and we wonder what benefits or investor protection these requirements will achieve. We urge the CSA to return to simple principles-based rules to enable fund managers and IRCs to work out procedures providing independent oversight over conflicts of interest, but that fit with the specific funds, fund complex and IRC.

4. ***NI 81-107 appears to be drafted in contemplation of significant governance concerns, which we submit is not supported by fact.*** We support tailored governance principles for the investment management industry and a form of independent oversight in the area of conflicts of interest. However, this version of NI 81-107 appears to be have been drafted in contemplation that the IRCs will unearth significant issues in the management of investment funds, which have been ignored by fund managers. We note above that this version of the rule is very detailed. Indeed, in our view, much of the detail arises from the CSA's attempt to build in mechanisms that will deal with anticipated significant issues raised by IRCs. We respectfully submit that there is no basis for this approach and accordingly all of NI 81-107 should be re-considered in light of the central duty of fund managers and the practical reality of the Canadian fund industry over the past 60-odd years. The vast majority of participants in the Canadian fund industry have operated for years keeping the best interests of investors in the forefront and in compliance with their fiduciary and statutory standard of care. The rationale for enhanced fund governance as articulated by the CSA continues

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to have as much relevance today as it did when the CSA first published its Concept Proposal in 2002[2].

5. ***NI 81-107 must be adopted as a national instrument.*** Regulation of investment funds (particularly mutual funds) has been uniform across Canada for many years. In our view, we do not understand why regulation of investment funds would ever be different in different provinces and territories of Canada, given the nature of the product and its national scope. If the CSA move forward with NI 81-107, we strongly urge the CSA to ensure that NI 81-107 is adopted on a uniform basis across Canada. At the very least, if one jurisdiction does not agree with NI 81-107, then that jurisdiction should ensure that they impose no competing regulation so that investment funds and their managers need only look to NI 81-107 for the regulation on governance in Canada.

Specific Comments on NI 81-107

1.2 Investment funds subject to Instrument

As noted above, we believe that some investment funds should be completely exempted from NI 81-107. For example, single investment purpose funds and split-share corporations where no decisions of the nature contemplated in NI 81-107 have to be made, have no need for independent oversight from a governance agency.

1.3 Meaning of conflict of interest matter

We have several concerns with this section, as drafted:

(a) It has no concept of "materiality" of a conflict of interest matter.

(b) It appears to be intended to include perceived conflicts, rather than conflicts in fact, through the use of words such as "may conflict" and "may impact".

(c) It focuses on matters where a fund manager has an *interest* that *may conflict* with the manager's *ability to act* in good faith and in the best interests of the fund. It is not that an *interest* conflicts with the manager's *ability to act*, but that a reasonable person would consider that the manager has a material interest in a matter that is materially different from or conflicts in a material fashion with the best interests of the fund.

(d) Commentary 1 appears to require a fund manager and an IRC to consider conflicts experienced by an unrelated portfolio manager. We do not understand how such conflicts ever could ("may") impact the manager's ability to act in good faith and in the best interests of the investment fund. Please also see our comments below on section 1.4 of NI 81-107.

[2] Please see the Overview to the CSA Concept Proposal 81-402 *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers* CSA March 2002, as well as the introduction to mutual fund governance.

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(e) The examples of conflicts of interest provided for in the first version of NI 81-107 have been removed.

(f) It is not clear whether the CSA intend for an IRC to act as an audit committee for the investment funds; is preparation of financial statements and liaising with auditors a "conflict of interest" matter?

We would like to repeat certain of our comments made on section 3.1 of the first version of NI 81-107 in our letter of April 16, 2004, because we continue to believe that the reasoning expressed in that letter and our recommendations would achieve the CSA's goals in moving forward with independent oversight. We note that certain of our comments were picked up by the CSA in redrafting section 5.1 (which is essentially section 3.1 of the earlier draft) and we have not reproduced text with which the CSA appeared to agree.

> While the concept of section 3.1 *[now section 5.1]* 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 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?

[text not relevant to this version of NI 81-107 not reproduced]

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.

[text not relevant to this version of NI 81-107 not reproduced]

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].

In our view, if the CSA continue to support a broader mandate for an IRC (ie. to consider all material conflicts of interest), we recommend that the test for "conflict of interest matter" be redrafted as we have highlighted above and that the list of potential conflicts of interest matters be reintroduced into the Commentary (with the modifications we recommended in April 2004).

1.4 Meaning of "entity related to the manager"

We do not understand the reference to "agent" in subsection (b) nor do we understand Commentary 1. Agent is a very broad term and legal concept and would potentially

include many service providers to a fund manager. The CSA has identified only "portfolio managers" in Commentary 1.

As we noted in our April 2004 comment letter (reproduced above), the conflicts experienced by an **unrelated** portfolio manager cannot be considered to be the conflicts of the fund manager and we recommend this be clarified. We recognize that a portfolio manager's interest would only be a conflict of interest matter (for the fund manager) within the scope of NI 81-107 where that interest "may conflict" with the manager's "ability to act in good faith etc.". In our view, considerable confusion will remain on the meaning of this concept. We consider that it would be practically impossible for the IRC of the applicable funds to dictate how a portfolio manager should manage their conflicts of interest. We believe that a prudent fund manager will consider whether a particular portfolio manager would have any material conflicts of interest in managing their fund, and if so, would expect the portfolio manager to explain to the fund manager's satisfaction how those conflicts of interest are managed. The fund manager in this case would be the ultimate "independent" overseer (since, in fact, the fund manager is independent of the portfolio manager) and there would be no need to seek IRC consideration of these issues.

Our comments on an unrelated portfolio manager would similarly apply to any unrelated service provider to a fund or fund manager (within the meaning of the word "agent").

1.5 Meaning of "independent"

We largely support the changes made to the definition of independence. However, we have four comments on the definition, the first two of which are related, and all are vital to the practical implementation of NI 81-107:

(a) As we pointed out in our April 2004 comments, we urge the CSA to introduce the "prescribed period" concept that is found in MI 52-110 *Audit Committees*, 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-date the Rule. The same rationale for introducing this concept to the Rule exists as for MI 52-110.

(b) Individuals that today act as the independent directors on the board of a fund manager must be able 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 NI 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 (and who are otherwise independent) may be tainted and not permitted to move over to form part of an IRC for their funds. We strongly recommend that the rule specifically permit existing independent fund manager board members to act as members of the IRC and the last paragraph in Commentary 3 be deleted (since it adds significant confusion).

(c) If a fund manager decides to use the board of directors of a registered trust company as its governance agency, if that trust company is related to the fund manager, all of the directors (even if they are independent within the meaning of trust company legislation) could be "tainted" according to this test. We point out that subsection 2.4(4) and the related commentary of the January 2004 version of NI 81-107 addressed this issue, both of these provisions have been removed from the latest version of NI 81-107. We recommend that the rule and commentary revert back to what was written in the first version of NI 81-107.

(d) Otherwise qualified individuals may hold investments in either the fund manager or its parent company (depending on the corporate structure). We recommend CSA commentary to the effect that this share ownership will not automatically "taint" the independence of those individuals, but that a fund manager and the individual member should review whether or not that share ownership is material to the individual having regard to that individual's total net worth and sources of other income.

1.7 Meaning of "manager"

Commentary 1 should be either deleted or significantly redrafted. We are unclear as to the intention of the CSA with this section. It would appear that the CSA are saying that (i) there may be circumstances where a fund will have more than one manager and/or (ii) the board of directors of an investment fund or general partner of a partnership that is an investment fund will be considered to be a manager. This will lead to significant practical confusion (not to mention odd results). For example, will both "managers" be required to establish an IRC? Will a board of directors of an investment fund (which is, by law, responsible for the business and affairs of the fund and that may have independent directors) be required to establish another governance agency – the IRC required by NI 81-107?

We assume this section is intended to capture investment funds that are not traditional mutual funds and that may not have a separate management company. We ask as a threshold question, how such an investment fund (a self-managed investment fund) could, at law, experience "conflicts of interest" within the meaning of NI 81-107, given the duties of a corporate director at law and the requirements for dealing with conflicts of interest experienced by those directors at law?

We recommend that the CSA undertake further industry consultation and consider further the appropriate form of governance to be mandated for the different types of investment funds that are not traditional mutual funds.

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2.2 Manager to have written policies and procedures

(a) *Subsection (1):* We note the phrase "or any other matter that securities legislation requires the manager to refer to the independent review committee" and recommend that similar commentary to that found with section 4.1 be included here, in order to better clarify what is meant by this phrase.

(b) *Commentary (2):* We note that not all conflicts of interest (within the meaning of NI 81-107) will result in "violations of securities legislation", therefore we believe this commentary is incomplete. Policies and procedures should be designed to prevent *any applicable* violations of securities legislation. More importantly, in our view, policies and procedures should be designed to prevent a fund manager from taking an action that would not be in the best interests of the funds (which we acknowledge would be a breach of section 116 of the *Ontario Securities Act).*

2.3 Manager to maintain records

Further clarity is needed in this section:

(a) What kinds of activities are contemplated? We recommend adding a requirement for a record of the actions that the Manager takes in respect of a conflict matter referred to the IRC.

(b) *Subsection (a):* Whose meetings are referred to? The Board of Directors of the Manager? The IRC? Committees of management of the Manager? If the minutes are minutes of meetings of the IRC, why will the Manager hold those minutes? How does this fit with the requirements in section 4.1 for meetings without management present? If they are not minutes of the IRC, what kind of meetings does the CSA expect to occur at the manager level?

(c) *Commentary 1* What is intended by the reference to "investment fund"? Section 2.3 does not apply to investment funds.

2.4 Manager to provide assistance

We recommend that the first word of this section ("if") be replaced by the word "when" to provide further clarity. We also recommend that the words "conflict of interest matter" used in the first line of subsection (1) be supplemented by a reference to policies and procedures of the fund manager that are designed to address a conflict of interest matter. Similarly, subsection 2.4(1)(a)(ii) should also refer to the fund manager's proposed policies and procedures in addition to its proposed course of action.

We also note the phrase "or any other matter that securities legislation requires it to refer to the independent review committee" in this section. Please see our comment above regarding the same phrase used in section 2.2.

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We urge the CSA to delete or at least provide further clarity around subsection (2). When would a manager be considered to have "prevented" or have "***attempted*** to prevent" an IRC from communicating with the CSA? For example, would a fund manager be considered to have *attempted to prevent* communications if it described to the IRC why its action was not contrary to its policies or did not constitute a conflict of interest, so as to persuade the IRC that it was not necessary to communicate with the regulators? What if the fund manager wrote a letter to the IRC explaining its position and asking the IRC to reconsider its position? As a practical matter, we do not see that a fund manager would have any ability to actually *prevent* communication between an IRC and the regulators, i.e. an individual IRC member always has the ability to write or call the regulators. We do not consider this section necessary or practical and we believe it will add unnecessary tension and uncertainty in dealings between a fund manager and an IRC. Our comments on this section are examples of our concerns we raise with our principal comment 4 above.

3.2 Initial appointment

This section is drafted as if no existing fund complex has an IRC. It should reflect the fact that some fund managers have already established an IRC or governance agency and therefore are not required to somehow "reappoint" these members. This section should also reflect that for some governance agencies, such as a board of directors of a registered trust company, the fund manager will have no ability to appoint the IRC (which would be either the board of directors or a special committee of that board of the trust company).

3.4 Written charter

We recommend that the Rule or Commentary clarify that any role that the IRC and the fund manager decided upon that is in addition to the role mandated by NI 81-107, be clearly not subject to the Rule. We recommend that commentary similar to paragraph 3 of section 2.5 of the January 2004 version of NI 81-107 be reintroduced. We fear that without this commentary and assurance, a fund complex or IRC member may be loath to take on any additional role given the complexity and responsibilities expected by NI 81-107. This comment is also relevant to section 4.1.

We do not understand the fourth bullet point in Commentary 3 and urge the CSA to provide further clarity on its meaning.

3.5 Composition

We are concerned with the Commentary in paragraph 2 about the expectations of the CSA for the duties of an IRC Chair. In our view, these expectations are onerous and could, in effect, require a full-time chair, which we believe is something the CSA does not intend. We recommend that this Commentary be simply deleted. If, however, the Commentary remains, it is essential that the CSA provide more detail as to what is meant by "regular communication" and the CSA's expectations for the Chair and why. Also, we do not understand why the Chair would seek information about the "operations of the investment fund" given the IRC's focus on conflicts of interest.

3.7 Standard of Care

We recommend that the Commentary (except the first sentence and Commentary 3) be deleted or modified in accordance with our comments. Although the common law defences may well be available to IRC members, it would be useful to articulate what these would be and why the CSA believes that they would apply, given that the CSA cannot mandate any judicial determination of this rule. We also respectfully disagree with the reference to an IRC member's role being analogous to corporate directors; we see significant differences. In any event, we do not see any need for this reference in the Commentary.

3.8 Ceasing to be a member

We recommend that subsection (3) be redrafted to provide further clarity. We recommend that the fund manager should have the ability to decide whether it believes an individual is no longer independent and therefore can remove that member and replace the member. It may do this on its own initiative or when other IRC members notify the manager that they consider the member to be no longer independent. Someone must make this determination and we recommend that the manager should have this responsibility and right. We do not see the necessity for the words "and the cause of non-independence is not temporary….". The test for independence is sufficiently clear and principles-based that either one is independent or one is not. We believe it is confusing to introduce a concept of being "temporarily non-independent".

We also strongly recommend that the rule permit a fund manager to remove an IRC member if that member becomes a member of an IRC for another fund complex. This should be a permissive rule (as opposed to mandatory removal), but given the sensitivities and competition in the industry, it may be that a fund manager will not want an IRC member to also be an IRC member for its competitors.

We disagree with the concept of immediate notifications to the regulators as contemplated in subsection (4). We recommend annual disclosure in an annual information form will be sufficient notice to the regulator and the public of any change in an IRC. We do not see the regulatory purpose of immediate notifications of changes in the IRC. What will the regulator do with this information? In what form will a notification be? Will it be "filed" or merely delivered? Will this information be publicly available?

3.9 Authority

While we understand why the CSA proposes to give the IRC the ability and authority to communicate with the regulators, we believe that this power should be restricted to matters within the IRC's mandate. To give complete "communication" powers could lead to unnecessary rigidity, tension and formality between a fund manager and an IRC. In this regard we are very much opposed to Commentary 3 for the above-noted reason. Good governance cannot take place in an atmosphere of tension and confrontation and we believe the CSA's expectations as drafted in Commentary 3 may foster this state of affairs. We refer to our principal comment 4 above.

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3.10 Fees and expenses to be paid by the investment fund

We recommend that this section be redrafted to require the fund manager to allocate the costs associated with the IRC on an equitable and reasonable basis amongst the funds for which the IRC acts. This section, as drafted is missing this concept and appears to assume all IRC costs will be paid for by one fund, which will not be the case for the large majority of fund managers.

We are also concerned with the specific requirement that there be disclosure in a fund's prospectus as to reimbursements. In our experience, reimbursement is not always tied to a specific expenditure but is done on an aggregate basis. We submit that the current MER waiver disclosure that already is required should be sufficient.

In addition, we note the CSA's response to our comment (made in our April 2004 comment letter) about the application of Part 5 of NI 81-102 to the introduction of governance costs for payment by the funds. We urge the CSA to include its response to that comment in the Commentary to this section so as to provide future clarity and guidance.

3.11 Indemnification and insurance

At the outset, we note that many in the industry, including lawyers at this firm, believe that an IRC member should have its liability completely limited by the CSA. At the very least, we submit that the CSA introduce commentary to the effect that NI 81-107 does not create any liability or responsibility on the IRC member provided the member meets the requisite standard of care.

We note that throughout this section, indemnities of the IRC by the manager are referenced. We submit that the fund manager should be free to provide the IRC member with any form of indemnity that the IRC member wishes to negotiate. Under what regulatory policy rationale would the CSA limit a fund manager from providing a complete indemnity to the IRC member? A fund manager in this situation is not an entity analogous to the "corporation" at corporate law and hence should not be restricted as to the nature of an indemnity as a corporation is at corporate law.

We recommend that further analysis and consideration be given to how a claim under an indemnification obligation should be worked into a daily NAV calculation for an investment fund. We feel this is a critical issue and should be addressed in the rule.

Section 3.11(6) should clearly indicate that the fund could pay for the cost of any insurance without the need for a security holder vote under Part 5 of NI 81-102.

3.12 Orientation and continuing education

We are unclear on the meaning of subsection (3). Why is this subsection considered to be important as a rule? Does this mean that an IRC can sign up for educational programs and charge the funds? What will happen if an IRC does not do this, given Commentary 1? Will the IRC be in breach of the Rule? We recommend that the CSA mandate that the IRC must consider the necessity of attending continuing education programs as a part

of its mandate and annually thereafter. This determination should be left to the IRC. Section 3.12 should be amended to make clear that the funds are permitted to bear the cost of this education.

Section 4.1 Review of matters referred by manager

We recommend that subsection (2) (b) be deleted to increase certainty. We believe, from a policy perspective, that it will be a backward step to **mandate** an IRC to "perform" other functions as may be agreed in writing. This will leave the IRC members open to enforcement actions for breach of securities legislation when they agree to carry out additional functions on a voluntary basis and are not considered to have fully carry out their duties. It will also make the performance of that function subject to the duties and requirements of NI 81-107. This may have the perverse effect of keeping fund governance at a minimal level, which we understand is not the intention of the CSA.

We are also concerned about the scope of subsection (3) and (5). Does this mean that absolutely no representative of the fund manager can be present? We know that IRCs will not likely hire staff to take minutes of meetings for example and that fund manager staff will likely be present to take minutes of meetings. Will this be permitted under NI 81-107? Will the manager be prohibited from viewing the minutes of the "confidential" meeting described in subsection (5)? If so, who will keep these minutes? If the manager is allowed to access the minutes, won't that defeat the stated intent of this meeting as described in Commentary 4?

Section 4.3 Reporting to the manager

We recommend that the words "or its suspects" be deleted as uncertain and vague. We do not know what this would entail and given that this section is a rule, could put the IRC members in an impossible situation. Please see our principal comment 4.

We also recommend that further guidance be given on the meaning or CSA intentions with the words "as soon as practicable".

Section 4.4 Reporting to securityholders

We urge the CSA to re-consider the purpose of this report to be prepared by the IRC.

Firstly, the rule, as drafted, does not contemplate an IRC acting as an IRC for multiple funds, each with different year-ends. For a fund complex with funds with year-ends at March 31, June 30, September 30 and December 31, the IRC for those funds would be required to prepare four sets of annual reports. We doubt this was intended.

Secondly, we note that, as a practical matter, unless there is a significant break down in governance and relations between the IRC and the manager, we very much doubt the reports will say much more than that mandated by (a), (b) and potentially (f). Is this intended? Does the CSA still consider these reports to be important or valuable to investors?

We are not opposed to some form of annual reporting, but only if there is something useful to report. Otherwise we recommend that the content and timing of reports to investors be left with the fund manager and the IRC to decide.

Please clarify what constitutes prominent displays on a Web site.

4.5 Reporting to securities regulatory authorities

We strongly urge the CSA to reconsider the scope and the underlying purpose for this section. Consistent with our principal comment 4 above, in our view this section presupposes a significant breakdown of governance, which in our view is unwarranted. The obligation to comply with securities regulation is rightly placed on the fund manager. If this section remains as drafted, IRC members will be obliged to report any and all issues, notwithstanding their significance and the fact that the fund manager may have already self-reported a material breach of securities regulation. Given that the IRC members could be subject to enforcement action if they fail to comply with this section, we submit that an IRC will err on the side of over-reporting than reporting only material breaches of securities legislation or material non-compliance with IRC conditions. In our view, the responsibility for reporting breaches of securities regulation must remain, as contemplated in Commentary 2, with the fund manager.

5.1 Manager to refer conflict of interest matters to independent review committee

5.2 Matters requiring independent review committee approval

5.3 Matters subject to independent review committee recommendation

5.4 Standing instructions by the independent review committee

In our view, Part 5 should reflect the following practical considerations, which we submit will be the most common way that a fund manager will obtain, and an IRC will provide, independent oversight over the fund manager's management of conflicts of interest.

(a) A fund manager must establish written policies and procedures to deal with conflicts of interest (within the meaning we recommend above) *[see section 2.2]*

(b) A fund manager must take these written policies and procedures to its IRC for review and input *[section 2.2]*

(c) A fund manager must consider the input of the IRC and its fiduciary obligations in finalizing these policies and procedures *[concept missing from section 5.1 and section 2.2]*.

(d) Thereafter, the fund manager must follow these policies and procedures in dealing with any conflict of interest *[concept missing]*

(e) If the fund manager wishes to take a different action which is not permitted under its policies and procedures it must take this proposed

action to the IRC for review and input *[concept missing, but inherent in section 5.1]*.

(f) The fund manager must report regularly to the IRC on its compliance with its policies and procedures and how it has dealt with any prior input from the IRC and must therefore report on any non-compliance with those policies and explain why the particular action was taken. Inadvertent non-compliance should be distinguished from deliberate non-compliance, where the fund manager decides to take a different approach from that provided for in its policies and procedures (see (e) above) *[concept missing]*

(g) The IRC must annually review the manager's policies and procedures and provide input *[section 4.2]*.

(h) The fund manager must take any unique conflicts matter to the IRC for review and input that is not specifically addressed by a policy or procedure that has been previously reviewed by the IRC *[concept inherent in section 5.1]*

We recognize that the CSA has decided to divide IRC input into "recommendations" and "approvals" and we do not comment on this decision.

We do not understand the need for section 5.4, which contemplates that the IRC *may* give "standing instructions". In our view, section 5.4 will allow (basically) the fund manager to follow its policies and procedures, which we submit should be a mandatory requirement. We disagree with the concept that an IRC merely "may" give standing instructions (permissive)—in our view, if the IRC has essentially agreed with policies and procedures, then the fund manager must be free to follow those policies and procedures. Also, if an IRC wishes a fund manager to follow additional or different procedures with respect to managing a specific conflict of interest, then that procedure should be written into the fund manager's policies and procedures, rather than being part of a free-standing "standing instruction".

Part 5 (and perhaps section 2.2) needs to recognize that there may be instances when the fund manager inadvertently does not follow its policies and procedures or does not follow its policies and procedures because of a particular fact situation. We submit that a fund manager should be required to seek prior IRC input in advance of any proposed decision to *materially* deviate from its policies and procedures, but that otherwise, as a matter of course, it should report regularly (perhaps at every meeting) to the IRC on how it has complied with its policies and procedures.

Section 5.1 appears to suggest that the fund manager will be regularly taking unique conflict matters to the IRC that have not been dealt with via a conflicts policy and procedure. When coupled with section 5.4, section 5.1 also appears to suggest that a fund manager would be required to take each conflict matter to the IRC before taking any action, even though it proposes to follow its policies and procedures in managing that conflict of interest. In our view, a fund manager will take unique conflicts circumstances to the IRC, as an exception rather than as a rule.

In light of our recommendation that sections 5.1 to section 5.4 be redrafted, we do not provide detailed comments on these sections, other than as follows:

(a) We do not understand the test in subsection 5.2(2). In particular, why does the CSA care if the manager is free from influence as required by the test in (a) or uninfluenced as required by the test in (b). Given that this issue is an example of a conflict in fact, we submit the IRC must assume there is a potential for influence and notwithstanding that influence, must decide whether the manager's proposal will achieve a fair and reasonable result for the fund.

(b) Subsection 5.4(3)(b) does not allow a fund manager to continue to follow "standing instructions" during the time of the IRC's regular assessment of these standing instructions. We believe this is not a practical result. If a policy and procedure or standing instruction relates to an activity or action that occurs regularly, it may not be in the best interests of the fund or investors for that action or activity to cease while the IRC considers the policy and procedure or standing instruction, which may take some weeks to resolve.

(c) We wonder about the need for such detailed instructions to an IRC as contained in Commentary 2 of section 5.4. What does the CSA mean with the instruction in the second paragraph of Commentary 2 regarding prior CSA orders? We submit that an IRC will be reluctant to deviate from prior orders, even when it does not believe a particular condition is relevant, given this guidance. We believe this is inappropriate.

(d) Why is Commentary 3 to section 5.4 considered necessary?

Section 6.1 Inter-fund trades

We provided comments on the CSA's proposals regarding inter-fund trading in the first version of NI 81-107 and we wish to repeat them. We continue to recommend that the proposals in this regard are overly prescriptive and do not recognize (i) the fiduciary obligations of the fund manager and (ii) the input from the IRC. We believe that the CSA should either (a) provide detailed rules (but only with the changes we recommend) to permit inter-fund trading and *not* require IRC input or (b) provide no detailed rules and allow the IRC and the fund manager to follow their obligations and responsibilities.

In particular we submit that subsection 6.1(1)(a) should be deleted. If it makes sense for a public investment fund to trade with a pooled fund or another account managed by the fund's portfolio manager (and we believe in many circumstances it does), why does the rule not allow this, provided the other protections of the rule are in place.

We also do not agree with the detailed focus on inter-fund trading in a rule that is intended to deal with fund governance and independent oversight. Private trades not made through a dealer should be dealt with, if anywhere, in a rule that is broader in scope than focused on publicly offered investment funds. We do not understand why the CSA has chosen to focus on inter-fund trading, when other important operational matters

relevant to investment fund management, such as error correction, remain outside of the realm of specific regulation.

We repeat our comments on this section as provided in our April 16, 2004 comment letter:

> As a general comment, we view the proposed inter-fund trading rules in section 3.3 [now section 6.1] 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.

Section 6.2 Transactions in securities of related issuers

Subsection 6.2 (1) should not be restricted to "investment in the securities of an issuer related to it, its manager or an entity related to the manager". Rather it should be extended to any investments prohibited under the "mutual fund conflict of interest investment restrictions".

Subsection (1)(c) speaks of the manager of an investment fund "filing" *particulars of the investment.* We recommend that this notification should be included in either the financial statements or the MRFP required by NI 81-106 and should not be a separate notice that would be filed. Indeed, it is arguable that this type of disclosure is already mandated in the section of the MRFP form under the heading "Related Party Transactions".

Section 7.2 Existing exemptions, waivers or approvals

We commented on this section in connection with the January 2004 version of NI 81-107. We acknowledge the CSA's response that they are satisfied that they have the authority to make such a rule, but we repeat our comments made in our January 2004 letter and ask the CSA to re-consider our comments:

> 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.

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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?

Section 8.2 Transition

We provided comments on the transitional sections of the first version of NI 81-107 in our April 2004 comment letter that remain relevant.

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.

We also recommend that the CSA permit the same transition period for all investment funds, whether established before or after the coming into force of this rule.

For fund complexes that decide to establish a new fund for their fund families, section 8.2 will require immediate compliance with NI 81-107 for that fund. This will lead to an odd result and practically would necessitate the fund manager to set up an IRC for all its funds at the same time as the new fund.

We also do not understand the purpose for subsection (4). Why would this notification be useful and what would the regulators do with this information? We recommend that it be deleted. As noted above, some fund managers already have a form of independent oversight, why should they be restricted from ensuring they comply with NI 81-107 once it comes into force?

Comments on Proposed Amendments to NI 81-101

We have the following comment on this amendment instrument.

We strongly recommend that the disclosure item referred to in subsection 4(c) [new Item 15(2)] be deleted. Disclosure of individual compensation and expenses do not appear to be warranted for any regulatory purposes. We do not understand why this form requirement is only included in the mutual fund prospectus form (including the prospectus for a commodity pool) and not for other types of investment fund.

Comments on Proposed Amendments to National Instrument 81-102

We have the following comments on this amendment instrument.

1. We have the same comments on the proposed amendments to sections 4.1 and 4.2 [proposed subsection 4.1(d) and proposed subsection 4.2(c)] as we do on section 6.2 of NI 81-107.

2. We note that the proposed amendment to section 5.3 should also reference paragraph 5.1(g) as well.

3. We wonder if the guidance provided by the CSA in proposed subsection 3.8(2) is really a rule, rather than a policy. The words used in this policy are explicit and mandatory in nature.

Comments on Proposed OSC Rule 81-802

We have the following comment on this proposed rule.

Rather than specifying in such detail the sections to which a manager or investment fund or portfolio manager is exempt (contained in sections 3.4 and 3.5) we recommend that the rule should provide that these applicable entities are exempt from sections 111 to 118, inclusive, to the extent that the IRC has approved a particular action that would otherwise

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be prohibited or restricted by these sections to the same extent. This will provide clarity on the applicable exemptions, so as allowing for easier compliance.

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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 Investment Management Practice Group if you wish to discuss our comments with us.

Yours truly,

"Borden Ladner Gervais LLP"

Investment Management Group of
Borden Ladner Gervais LLP