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Governance of Canadian Mutual Funds: Reality, Regulation and Reforms

Outline
by
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The American Enterprise Institute
for Public Policy Research
The Regulation
and Structure of Collective Investment Vehicles
outside the United States
Washington, D.C
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1. Current Canadian mutual fund regulation relies principally on:

   (a) The fund manager's twin fiduciary obligations to the mutual funds it manages:

      (i) Duty of loyalty: to manage its mutual funds "honestly, in good faith and in the best interests of the mutual funds" and

      (ii) Duty of competence: to manage its mutual funds exercising "the care, diligence and skill that a reasonably prudent person would exercise in the circumstances".

   (b) Disclosure to investors about each mutual fund to facilitate informed decision making at the point of sale: "full, true and plain disclosure of all material facts" in a simplified prospectus (delivered to all investors) and an annual information form (available on request).

   (c) Disclosure to investors about the performance of each mutual fund on a continuous basis, through audited annual financial statements, unaudited semi-annual financial statements, annual and semi-annual management reports of fund performance, proxy disclosure and quarterly portfolio disclosure (all documents publicly available and available on request and must be delivered if investor so indicates).

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(d) Fund manager accountability for prospectus and continuous disclosure (through civil remedies granted to investors in securities legislation).

(e) Regulation of the mutual fund and some aspects of how it is managed, for example through regulation of:

(i) investment restrictions and practices

(ii) custodianship

(iii) valuation

(iv) purchases and sales

(v) sales communications

(vi) sales practices (between fund managers and distributors)

(vii) prohibitions on certain enumerated related party transactions (for example, investments in related companies, transfers in of principal holdings by fund managers and portfolio managers).

(f) Regulation (and registration) of portfolio managers and dealers (but not including fund administrators and managers).

(g) Rights of investors, including rights in the face of material changes to the mutual fund:

(i) Reinforcements of the right to redeem on demand through product regulation.

(ii) Timely disclosure of material changes to the mutual fund (through press releases and prospectus amendments).

(iii) Right to vote on certain enumerated proposals to effect fundamental changes (increases in fees, changes in manager, change of fundamental investment objective, fund mergers, change of auditors).

(iv) Need for regulatory approvals for certain fundamental changes, such as change in manager and fund mergers.

(h) Regulatory oversight through prospectus reviews and on-site compliance examinations.

2. At present, Canadian regulation does not require any form of independent oversight over how a mutual fund is managed. Conflicts of interest are handled through strict prohibitions and restrictions on self-dealing (although regulatory exemptions and relief can be received). Board of directors of the fund manager

(which need not have any independent members) are responsible for governance of the mutual fund.

3. Over the past ten years, Canadian industry participants and regulators alike have focused on the need for enhanced fund governance, through some form of mandated independent oversight, as well as through a focus on regulating the mutual fund manager, either in addition to, or in substitution for, the product (the mutual fund). The goal has been to reinforce the fund manager's fiduciary responsibilities to investors and to enhance investor protection from loss due to potential improper handling of conflicts of interest by a fund manager.

4. Regulatory initiatives resulted in a concept paper of the Canadian Securities Administrators *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers* released for comment in March 2002. Five-pillared regulatory scheme recommended:

   (a) Registration of fund managers and additional regulation of their operations.

   (b) Independent oversight of the management of mutual funds by an independent governance agency designed to enhance the fiduciary responsibilities of fund managers and to replace the reliance on prohibitions on certain conflicts of interest.

   (c) Streamlined product regulation for mutual funds that takes into account the other elements of the regulatory framework.

   (d) Continued reliance on disclosure as a regulatory tool, as well as protections for investor rights.

   (e) Continued regulatory presence, including enhancements in the areas of ensuring compliance with applicable laws.

5. Continued work in the area of fund governance resulted in the publication for comment of National Instrument 81-107 *Independent Review Committee for Investment Funds* in January 2004, along with its second publication for comment in May 2005. NI 81-107 is expected to be become law later in 2006 or early 2007.

6. The principal elements of proposed NI 81-107 (in the May 2005 proposals) include:

   (a) NI 81-107 will apply to all investment funds that are reporting issuers, not just mutual funds subject to National Instrument 81-102.

   (b) A manager of an investment fund must establish an independent review committee (IRC) within 6 months of NI 81-107 coming into force. The IRC must consist of at least 3 individuals, each of whom must be independent (within the meaning of NI 81-107) and one of whom must act as chair and carry out prescribed duties. Only the IRC can fill vacancies or

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add additional members once the IRC has been established by the fund manager.

(c) IRCs will focus on the conflicts of interests that face a fund manager, but will also be responsible for monitoring how conflicts are managed at a portfolio manager level. The phrase "conflict of interest matter" is broadly defined, using a reasonable person test. If an IRC mandate is to expand to areas that are not contemplated by NI 81-107, both the manager and the IRC must agree, but if agreed, the expanded mandate and the operations of the IRC fall within the purview of NI 81-107. An IRC will have duties to take into account certain prescribed matters when considering conflicts of interest.

(d) Fund managers will be required to refer all conflict of interest matters to an IRC before taking any action in respect of those conflicts. The IRC must approve certain specified conflict matters; generally those that are prohibited under securities legislation. For all other conflicts matters, the IRC must give the fund manager its recommendations about how the fund manager should manage those conflicts. A fund manager must abide by an IRC decision on matters that require IRC approval and must consider, but may disregard, an IRC recommendation.

(e) Fund managers must prepare written policies and procedures for dealing with conflict of interest matters and refer those policies and procedures to the IRC for review and input. Fund managers must also take each specific conflict situation covered by the policies and procedures to the IRC for its approval or recommendations, as the case may be. "Written standing instructions" can be given by an IRC in respect of a particular conflict of interest matter, including matters that the IRC must approve, but they must be reviewed in detail every year.

(f) The IRC can require the fund manager to report to securityholders if it chooses to disregard a recommendation, and must report to the securities regulatory authorities if the manager does not comply with an IRC approval. An IRC may contact the regulators at any time without any influence by a fund manager. An IRC will have no authority to require a fund manager to call a securityholder meeting.

(g) A fund manager will be exempt from certain, but not all, prohibitions on related party transactions contained in securities regulations if the IRC approves the relevant action. In addition, detailed prescriptive rules will apply if a fund manager wishes to engage in inter-fund trading and related party underwritings.

(h) Auditors of funds can be changed and certain fund mergers may occur without securityholder approval, if the IRC approves of the change.

(i) Complex annual assessments must be carried out by an IRC and reported on in writing to the fund manager. The IRC must also annually prepare a

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prescribed report to securityholders that must be filed with the regulators and made available for securityholders via, among other things, “prominent” postings on fund manager Web sites (if they have one). A fund manager must notify securities regulators upon any IRC member resigning, being removed or not reappointed, explaining the reason for such action.

7. Feedback to date on the proposals has been mixed, but regulators can be expected to move forward in 2006 to mandate some form of independent oversight. Canadian regulators are also considering some enhancements in the area of compliance regulation (likely borrowing concepts from regulation in the United States).

8. Some issues voiced by Canadian industry participants regarding proposed NI 81-107:

   (a) Costs of the new proposals v.s. the benefits to the industry and to investors, who will pay for the enhanced governance.

   (b) Need for 100 percent independence on the IRC v.s. need for some management representation to ensure appropriate understanding of the fund complex and business. Concerns about the lack of ability of fund managers to change composition of the IRC once it has been established.

   (c) Need for more definition of the concept of “conflicts of interest”. What will this term mean to different fund complexes, in the face of vague “principles-based” rules? Will there be marked differences in governance among Canadian fund complexes because of this lack of definition?

   (d) Concern about finding the right people to become members of IRCs. Close to 100 fund managers offering in excess of 4, 000 mutual funds in Canada today. Conservative estimates are that 300 independent individuals, somewhat knowledgeable about mutual funds and the investment management industry are needed in a short space of time (by mid-2007 on current timing).

   (e) Need for more definition of the role of the fund manager v.s. the role of the IRC. How will the two organizations inter-relate? How will the IRC report to the fund manager? To the regulators? To investors?

   (f) What kind of policies and procedures will a fund manager need to put in place and how will the IRC review these to ensure appropriateness for investors? To what standard should they review these policies and procedures?

   (g) Will investors ultimately be any further ahead through these new proposals, particularly given the anticipated variances in conduct and implementation of NI 81-107? Some skepticism about the ultimate benefits of the enhanced governance model proposed by the regulators.

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(h) What about other regulation of mutual funds and their managers. Is NI 81-107 going to be an additional form of regulation? Will the regulators conduct a review of existing regulation in light of the new proposals?

9. Issues could be solved through:

   (a) Better definition in the rules.

   (b) More education of industry participants.

   (c) Phased-in compliance.

   (d) Development of industry best practices.

   (e) Continued regulatory and industry dialogue and feedback.

10. Implementation can be expected to be "bumpy" particularly in light of the relatively clean compliance record of the Canadian investment management industry and the perception that nothing more is needed in the way of new regulation. Smaller fund managers, who are not part of financial conglomerates (and therefore have no related party dealings), can be expected to be particularly bemused about the need for enhanced fund governance in the form of NI 81-107 as it applies to their management of their funds.

11. Given the long history of mutual funds in Canada, some implementation difficulties can be expected. Acknowledgement of the difficulties of imposing "new regulation" on an existing industry with a good history and in the absence of scandals. Canadian regulation of mutual funds is not a blank slate, hence the need for regulatory sensitivity and enlightened industry participation in development of best practices.

12. Overall, recognition that some additional oversight is a good thing for the Canadian mutual fund industry, given its size and importance for Canadian investors. Still a lack of consensus on the form of oversight and the details on the proposals. Ultimately, the Canadian industry will move to enhanced governance, but it may take additional time and continued work on the part of the industry to embrace best governance practices.

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