

Canadian Securities Regulators Propose Mandatory Investment Fund Oversight

On May 27, 2005, the Canadian securities regulators released for comment proposed National Instrument 81-107 *Independent Review Committee for Investment Funds*, as well as related amendments to existing rules. Consistent with the January 2004 publication of NI 81-107¹, this version focuses on independent oversight over conflicts of interest of fund managers, but it contains substantively different and additional requirements. In many ways, it is a direct response to the perceived need for enhanced oversight and governance for investment funds in light of the findings from the regulatory scrutiny of investment funds over the past couple of years in Canada and the United States.

As we describe in more detail in this Advisory, if adopted in its present form, NI 81-107 will impose detailed—and onerous—obligations on fund managers as well as on members of independent review committees (IRCs). Consistent with the CSA's recent concentration on similar regulation for all collective investment schemes (such as the continuous disclosure requirements), NI 81-107 now would regulate oversight and governance for all publicly offered investment funds and not just publicly offered *mutual* funds.

Comments on this version of NI 81-107 are due by August 25, 2005. The British Columbia Securities Commission has asked, in a separate notice, for responses to four fundamental questions aimed at identifying alternative regulatory responses and continuing to examine the costs versus the benefits of the CSA's proposals, particularly for smaller fund groups.

We believe modifications to NI 81-107 are essential to ensure that Canadian investment fund governance properly reflects the existing regulatory regime, as well as the respective roles and responsibilities of industry participants. We intend to comment by the deadline, as well as work with The Investment Funds Institute of Canada in providing industry-level comments. In our view, it is critical that industry participants affected by this regulation, including members of existing governance agencies, understand the significant impact NI 81-107, if enacted in its current form, will have on their operations and make their views known to the Canadian regulators. **This may be the last chance we have to comment on NI 81-107.** We would be pleased to discuss how NI 81-107 would apply to you and to assist you in preparing a comment letter.

¹ Our Advisories on the first version of NI 81-107 and the CSA Concept Proposal that preceded it are available on our Web site www.blgcanada.com; Publications; Capital Markets. See *Mutual Fund Governance: Moving Closer to Reality* Investment Funds Advisory February 2004 Borden Ladner Gervais LLP and *CSA Fund Governance Proposal 81-402 Top 10 Issues For Comment* Investment Funds Advisory March 2002 Borden Ladner Gervais LLP.

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The Essentials of Proposed NI 81-107

- ◆ NI 81-107 will apply to all investment funds that are reporting issuers, not just mutual funds subject to National Instrument 81-102.
- ◆ A manager of an investment fund must establish an 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.
- ◆ IRCs will focus on the conflicts of interests that fund managers face, but may 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.
- ◆ 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.
- ◆ Fund managers must prepare written policies and procedures for dealing with conflict of interest matters and refer those policies and procedures to an IRC for review and input. Fund managers must also take each specific conflict situation covered by the policies and procedures to an 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.
- ◆ An IRC can require a fund manager to report to securityholders if the manager chooses to disregard a recommendation, and must report to the securities regulatory authorities if the manager does not comply with an IRC decision on matters that require 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.
- ◆ 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.
- ◆ Auditors of mutual funds can be changed and certain mutual fund mergers may occur without securityholder approval, if the IRC approves of the change.
- ◆ 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 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.

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National Instrument 81-107 will apply to all public investment funds

In recognition that managers of other investment funds face similar conflicts of interest as those experienced by managers of mutual funds, NI 81-107 will apply to all investment funds that are reporting issuers. This will include publicly offered mutual funds subject to National Instrument 81-102, closed-end funds, labour sponsored investment funds, exchange-traded funds, commodity pools, scholarship plans, split-share corporations, and certain deferred sales financing and flow-through share limited partnerships. We expect that NI 81-107 will not work perfectly for all types of investment funds and we recommend that investment funds that are not NI 81-102-mutual funds consider how NI 81-107 can be implemented having regard to their particular business model and third party relationships. Exemptions from NI 81-107 may be warranted for some funds.

Investment funds may be internally managed (generally through a board of directors or general partner) or do not have decisions to be made (such as split-share corporations or single purpose funds) and accordingly will not have a "manager" as contemplated by NI 81-107. In the commentary on the definition of "manager", the CSA appear to suggest that a board of directors of an investment fund established as a corporation and a general partner of an investment fund established as a partnership would be a "manager" within the meaning of NI 81-107. This would mean that the board or general partner must establish a separate IRC to carry out the duties proposed by NI 81-107. A board member may have no "divided loyalties" and legally is required to oversee the management of the fund in the best interests of the investors in the fund. The CSA also

appear to suggest that more than one entity can be a manager within the meaning of NI 81-107. We believe the CSA's analysis in this area should be clarified and modified.

A fund manager must establish a completely independent IRC

Each investment fund must have an IRC consisting of at least three members, all of whom must be independent. The initial members are to be appointed by the fund manager. We note that NI 81-107 does not recognize that some investment funds already have an existing IRC—an advisory board, a board of governors or a board of directors (either of the investment fund or of a trustee)—that could act in the capacity expected by NI 81-107 and do not need to be, and in some cases, cannot be appointed by the fund manager.

The fund manager will control the size of the IRC and must consider the work-load of the IRC to determine the optimal size that will "facilitate effective decision-making". As with the first version of NI 81-107, an IRC may act as the independent review committee for more than one investment fund.

All members of the IRC must be independent within the meaning of NI 81-107. The definition of "independent" is now described as being purely "principles-based"—one must look at whether an individual has a "material relationship" with the manager, the fund or an entity related to the manager. The CSA commentary appears to suggest that material relationships are primarily present relationships, but little guidance is given about past material relationships that no longer exist.

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One member of an IRC must act as chair of the IRC and, as chair "manage the mandate and responsibilities" of the IRC. The CSA comment that they expect that the chair will have "regular communication" with the fund manager between meetings of the IRC to keep up to date on the affairs of the investment fund and the manager. In our view, this expectation is not consistent in practice with the role of the chair and the IRC, which is to oversee conflicts and not manage or supervise the day-to-day management of the fund.

IRC will focus on "conflict of interest matters"

An IRC will have three duties mandated under NI 81-107

- Decide whether to permit the fund manager's proposals to make certain investments that are today prohibited by securities legislation
- Consider the fund manager's proposed action concerning any other "conflict of interest matter" (as defined in NI 81-107) referred to the IRC by the fund manager and make a recommendation to the fund manager in respect of that proposed action
- Review and provide input on the fund manager's written policies and procedures concerning "conflict of interest matters"

An IRC of a mutual fund will have two additional duties

- Approve certain fund mergers proposed by the fund manager
- Approve a change of fund auditor proposed by the fund manager

An IRC and a fund manager can agree that the IRC will take on additional functions, in which case, the IRC's

performance of those duties will be regulated by NI 81-107. In our view, this provision may have the perverse result of dissuading fund managers and IRC members from agreeing to expand independent oversight over other areas of fund management, which was one of the primary goals of the CSA, given the extent of the reporting, disclosure and other elements of NI 81-107.

The term "conflict of interest matter" remains very broadly defined using principles-based, reasonable person terminology. For example, a conflict of interest matter would likely include a perceived conflict, even when no actual conflict exists. The CSA have dropped much of the commentary provided in the first version of NI 81-107 that gave examples of different conflicts that likely would be captured by the definition of "conflict of interest matter". In our view, these examples were useful as illustrations of the scope of this all-important definition.

Contrary to our submissions to the regulators on the first version of NI 81-107, the CSA now suggest that a fund manager must be cognizant of conflicts of interest faced by an unrelated portfolio manager and take those conflicts to the IRC. Even if the manager achieves the difficult task of knowing about the conflicts of the portfolio manager, these conflicts will likely not be conflicts of the fund manager. We believe this provision will be unworkable.

IRC will carry out its duties as prescribed by NI 81-107

Some guidance is provided on how an IRC will carry out its mandated duties. For example, an IRC must generally consider whether the fund manager's proposed actions will achieve a fair and reasonable result for the investment funds

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in question. However, for the categories of conflicts where the IRC must approve certain matters, the CSA prescribe specific issues that the IRC must consider, including whether the fund manager's proposal has been influenced by a related party and whether it represents the business judgment of the manager uninfluenced by considerations other than the best interests of the funds.

Fund managers must refer "conflict of interest matters" to the IRC

As with the first version of NI 81-107, a fund manager will be required to refer all "conflict of interest matters" to the IRC before taking any action in respect of the matters. However, a fund manager cannot take any action without IRC approval in connection with the following conflicts

- Inter-fund trading
- Purchasing or continuing to hold securities issued by specified issuers related to the fund manager and
- Purchasing securities underwritten by entities related to the fund manager within 60 days of the end of the distribution period for those securities

A fund manager must comply with the IRC's decision, including any conditions imposed. The IRC must report to the securities regulators any instance of non-compliance, including any instance of "suspected" non-compliance. All other conflict of interest matters must be referred by the fund manager to the IRC for IRC recommendations. A fund manager may disregard a recommendation by the IRC, although the IRC has the authority to require the fund manager to report this to the securityholders.

The regulators have included a requirement that all

investment fund managers follow a specified standard of care in managing investment funds. Although slightly different terminology is used, this standard of care is essentially the same as that mandated for mutual fund managers under various provincial securities legislation, such as, section 116 of the *Securities Act* (Ontario).

Fund managers must have written policies and procedures to deal with conflicts

Before a manager can act on a conflict of interest matter, it must have written policies and procedures to deal with that matter, which must have been considered by the IRC and reflect its "review and input". A fund manager must comply with these written policies and procedures and can only change them if they describe the change for the IRC and obtain their "review and input". NI 81-107 does not contemplate any deviations, either inadvertent or otherwise, from these policies and procedures.

Even though the IRC will have considered and approved a manager's conflict policies, the manager will still be required to refer each conflict matter that is the subject of those policies to the IRC for its recommendations, and in some cases, approval at the time the conflict arises. The CSA would permit an IRC to give "written standing instructions" that would allow a fund manager to act according to its policies and procedures. Standing instructions must be considered in detail every year and the fund manager must tell the IRC about each time it acted under the standing instructions. Notwithstanding that the CSA explain that they believe that their proposals will "improve the flexibility and timeliness of the manager's decisions", we believe there are practical issues raised by this somewhat cumbersome approach.

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An IRC will have policing and whistle-blowing duties

The IRC must report to the securities regulators any instance when the fund manager does not comply with one of their decisions or where the IRC "suspects" there has been non-compliance. The CSA also comment that in circumstances where the fund manager has acted beyond the scope of the IRC's decision that the fund manager will be in breach of securities legislation and it is incumbent on the fund manager to also report any such breaches to the regulators.

IRCs will have authority to communicate directly with the securities regulators. The CSA emphasize the importance they put on IRC reporting by mandating that a manager must "not prevent or *attempt to prevent* the IRC or a member of the IRC from communicating with the regulators". Indeed, the CSA encourage, through commentary, IRCs to inform the regulators of "any concerns that the IRC is not otherwise required to report". We believe these rules and the CSA commentary will create unnecessary formality and rigidity, if not tension, between a fund manager and an IRC.

An IRC will not have the ability to compel a fund manager to call a securityholder meeting to consider a specific conflicts matter. This was an important "safety valve" provided in the first version of NI 81-107.

Exemptions from securities legislation

Contrary to the suggestions in the CSA's 2002 Concept Proposal and the first version of NI 81-107, the CSA no

longer propose to amend the prohibitions and restrictions on certain related party transactions contained in securities legislation. Instead, the CSA will provide exemptions from the prohibitions that would otherwise prevent a fund manager from conducting inter-fund trading, investing in securities of related issuers or underwritten by related underwriters, provided the IRC approves, and in the case of inter-fund trading and related party underwritings, detailed prescriptive rules are followed by the fund manager. The CSA explain that based on their experience with exemptive relief applications, they are comfortable that IRC oversight and approval coupled with prescriptive rules, can be effective in addressing the conflicts of interest in these types of transactions. Other types of prohibited related party transactions have not been the subject of extensive regulatory relief and so the CSA have "less familiarity" with these transactions. They will continue to be prohibited, unless relief is granted by the regulators on a case-by-case basis.

Changes of auditor and fund mergers need approval of an IRC, but not securityholders

Amendments to National Instrument 81-102 *Mutual Funds* were published also for comment. These amendments would remove the requirement that securityholder approval be obtained for changes of auditors for mutual funds and certain mutual fund mergers, subject to the proviso that the IRC approves of these changes. Prescribed advance notice must be given to securityholders, as well as prescribed disclosure provided in prospectuses. No guidance is given to an IRC as to what it must consider in making the decision to approve these changes.

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IRC and fund manager to assess and report

Complex annual assessments must be carried out by an IRC of its and its members' effectiveness, its charter, the fund manager's policies and procedures, any standing instructions and the fund manager's compliance with the standing instructions or approvals given. An IRC must report in writing on its findings to the fund manager as "soon as practicable" after completing the annual assessment.

The IRC must also annually prepare a 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. This report must be prepared and filed no later than the deadline for the annual financial statements for each investment fund for which the IRC acts.

In addition, a fund manager must notify securities regulators upon any IRC member resigning, being removed or not reappointed, explaining the reason for such action.

What NI 81-107 does not cover

The CSA do not discuss important aspects of the 2002 Concept Proposal referred to in connection with the first version of NI 81-107, such as registration of fund managers or modifications to product regulation (the rules governing the structure and operations of a mutual fund) to reflect this increased regulation. In our view, it is important to view investment fund oversight in the context of the overall regulatory regime and governance practices including disclosure, the standards that apply to industry

participants and investment funds and compliance with, and enforcement of those standards.

When will NI 81-107 take effect?

Although the CSA have not suggested an effective date for NI 81-107, we anticipate that they will be working towards having it in force by year-end 2005. This may mean that no further comments will be solicited after the end of this current comment period. If NI 81-107 comes into force on December 31, 2005, for an investment fund that exists on that date, the transition timing proposed by NI 81-107 would require

- the fund manager to establish an IRC for that fund by June 30, 2006 (within six months after NI 81-107 comes into force)
- the IRC to adopt a written charter within three months after the IRC is established
- the fund manager to have its written conflicts policies and procedures in place within six months after the IRC adopts its written charter
- the fund manager to begin referring conflicts matters to the IRC within six months after the IRC adopts its written charter.

No transition timing is provided for an investment fund that is established after NI 81-107 comes into force, which would mean that those investment funds must immediately comply with the rules. We believe transition timing will be important for newly established investment funds.

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We have followed closely the developments in fund governance leading up to this most recent release. **John Hall** and **Lynn McGrade** are members of the Advisory Committee to the Ontario Securities Commission that was active in providing initial advice to the Commission following the 2002 release of the CSA Concept Proposal on fund governance. **Rebecca Cowdery** was the project leader on the fund governance proposals at the Ontario Securities Commission until July 2003 and currently participates on the working group at IFIC organized to provide industry-level comments on NI 81-107. **Kyle Pohanka** also participates on that IFIC working group, as he did after the release of the first version of NI 81-107.

If you would like to discuss NI 81-107 and how it will apply to you, please contact your usual lawyer in BLG's Investment Management Group or one of the following Investment Management Group leaders:

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