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# ***Canadian Mutual Funds: Reality, Regulation and Reforms***

***The Regulation and Structure of Collective Investment  
Vehicles outside the United States***

***The American Enterprise Institute for Public Policy  
Research***

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# Topics:

- **Overview of Canadian mutual fund industry**
- **Structure of Canadian mutual funds**
- **Today's regulation**
- **Regulatory reforms**



# Today's Canadian mutual fund industry

- **C\$608 billion in public (retail) mutual funds**
- **Close to 2,000 mutual funds managed/sponsored by close to 60 fund managers**
- **First Canadian mutual funds began in the 1950's**
- **Significant growth in the 1980s and increasing sophistication of market place and growing importance of mutual funds for average Canadians**



# Today's Canadian mutual fund industry

- **Ten fundcos dominate marketplace; this includes fundcos operated by 4 of the 5 major Canadian chartered banks**
- **Two of the top ten fundcos are Canadian offshoots of U.S. fundcos**
- **Most Canadian mutual funds sold through broker-dealer, including mutual fund dealer, distribution network, although bank fundcos benefit from direct distribution through bank branches**
- **Top Canadian fundco has a traditional tied sales force selling one of its major fund families**



# Today's Canadian mutual fund industry

- **Much industry consolidation in fund industry over past few years**
- **Top Canadian fundco acquired two major fundcos within past couple years**
- **Third Canadian fundco includes several families of mutual funds sponsored by previously independent fundcos**



# Today's Canadian mutual fund industry

- **Traditional retail classes: sales load, deferred sales load, level load and institutional classes (for institutional investors, including retirement savings plans and managed accounts)**
- **Traditional broker-dealer compensation structures paid by fundco out of profits**
- **Traditional fixed “management fee” structures, with unspecified “operating expenses” being paid by the fund = management expense ratios (MERS) per class**

# Structure of Canadian mutual funds

- **All Canadian mutual funds have a “manager”; a separate entity that is responsible for the business and affairs of the mutual fund**
  - Generally the fund sponsor; the entity that establishes a family of mutual funds
  - May outsource all services for the fund, including portfolio management, fund administration, fund valuation and accounting
- **All assets must be held by a third party custodian (functionally independent, but may be part of same group as fund manager)**



# Structure of Canadian mutual funds

- **Most established as trusts, although increasing numbers established as corporations**
- **Income tax considerations (generally) dictate structure: in reality not much difference from a practical operational (and structural) perspective between trusts and corporations**
- **Trustees (by law) must be (i) individuals (ii) qualified trust companies or (iii) the manager of the mutual fund - most funds have the manager as the trustee; only a handful use individual trustees or trust companies**



# Structure of Canadian mutual funds

- **Governance primarily at the fund manager level; some fund manager boards of directors have independent directors**
- **Some fundcos have established governance agencies to provide some level of independent oversight: primarily advisory in nature at present**
- **Some fundcos have public shareholders, in which case the governance of the mutual funds are also considered at the public company board level (which must have independent members)**



# Today's regulation

## ■ Principal reliance in securities regulation on:

- Fiduciary responsibilities of fund manager
- Disclosure (POS and continuous), fund manager accountability for that disclosure and annual audits of financial statements
- Regulation of the mutual fund and some aspects of fund management, including custody of assets and prohibited related party transactions
- Regulation and registration of portfolio managers and dealers (not fund managers)
- Ensuring rights of investors (to redeem, to vote on fundamental changes)
- Regulatory oversight



# Regulatory Reforms

- **At present no form of mandated independent oversight**
- **NI 81-107 by Summer 2006: Final Rule and implementation by early 2007**
- **One IRC per fund group (although fund manager can establish multiple IRCs for its funds)**
- **Minimum of 3 individuals needed for each IRC = conservative estimate: 300 people needed by early 2007 to serve on Canadian IRCs**
- **100 % independent from fund manager and corporate complex**



# Regulatory Reforms

- **Focus on conflicts of interest and make recommendations on fund manager actions**
- **Emphasis on the fund manager retained, with ability to make decisions, taking into account recommendations of IRC, with attendant accountability**
- **Reporting obligations**
- **Annual assessments**



# Regulatory Reforms

## ■ What's needed in NI 81-107 and its implementation

- Better definition of, and industry acceptance of meaning of “conflicts of interest”
- Concerted effort to develop industry best practices
- Phased-in enlightened compliance
- Continued regulatory and industry dialogue and feedback



# Regulatory Reforms

## ■ Will it be a bumpy ride?

- Acknowledge difficulties of imposing “new regulation” on an existing industry with a good compliance record and no history of scandals
- Acknowledge confusion of (in particular) smaller fund managers (and their IRCs) who are not part of a financial conglomerate “what conflicts will we have?”



# Regulatory Reform

## ■ Overall:

- Additional oversight is a good thing for the Canadian mutual fund industry, given its size and importance to Canadian investors
- But, will the benefits justify the costs (payable by those same Canadian investors)?



# Regulatory Reform

- **Proposed NI 81-108 Investment Fund Compliance Plan Rule by Summer 2006?**
- **Fall-out from the OSC Trading Practices Review (market timing and late trading)**
- **Compliance and fair value pricing**
- **Elements from U.S. Rule(s)?**
  - CCO
  - Compliance policies and procedures “reasonably designed” to ensure compliance with applicable Canadian “securities laws”
  - Annual testing and reporting
  - Oversight? IRC involvement? CSA involvement?



# Regulatory Reform

- **NI 81-101 in force February 2000**
- **Rethinking Point of Sale February 2003**
  - Seg funds/mutual funds
  - Summary Document, with Foundation Document and Education Document
  - Continuous Disclosure Documents
  - Responsibility for delivery? And who must disclose what – and when – and how?



# Regulatory Reform

- POS project now has priority
- Increased attention on roles and responsibilities of dealers/advisers on ensuring investors make informed decisions
- Who should give what information? And when? Where does the fund and the fund manager come in? What about disclosure about the “product”? What about “cooling-off” rights? Similarities to US initiatives



# Regulatory Reform

## ■ Questions on Canadian POS reform:

- Will it replace the after the fact delivery of SP?
- What about statutory rescission and withdrawal rights?
- Who is responsible for preparing document?  
Combination of broker-dealer and fund manager?  
Liability?
- What is important information?
- How will it get to investors? When? Who is responsible for delivery?
- Will CSA wait until the U.S. settles down?



# Questions

■ Thank you

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