

**Concept Proposal 81 - 402**

**Striking a New Balance:  
A Framework for  
Regulating Mutual Funds  
and Their Managers**

**Concept Proposal  
of  
the Canadian Securities Administrators**

**March 1, 2002**

# An overview

## What is this concept proposal about?

In this paper the Canadian Securities Administrators (the CSA or we):

- outline the CSA's renewed vision for mutual fund regulation in Canada; and
- detail proposals to reform the current regulatory framework—including our proposals to improve mutual fund governance.

## A truism: the importance of the mutual fund industry to Canadian consumers

We know we state the obvious when we remark that the mutual fund industry in Canada has experienced tremendous growth in the last two decades. It is equally obvious that Canadian investors continue to place unprecedented amounts of money into mutual funds and other similar investment vehicles. The assets under management by mutual fund managers have grown more than threefold since Glorianne Stromberg published her seminal report recommending changes to our mutual fund regulation in 1995.<sup>1</sup> As of January 31, 2002, Canadians had invested \$427 billion in over 2,500 mutual funds managed by some 75 mutual fund managers. Based on demographics we know this trend will continue and will likely accelerate.<sup>2</sup> Certainly a sizeable amount of public money and, by extension, public trust is invested—and will continue to be invested—in this key segment of the financial services marketplace.

## Our mandate

We are charged with regulating this maturing industry and it is incumbent upon us to ensure that our regulation keeps pace not only with the complexity and creativity of the industry, but also with global standards. We must strike the correct balance between protecting investors and fostering fair and efficient capital markets where healthy competition and innovation can operate to multiply investment choices and services. All the while, we must be cognizant of the fact that the Canadian mutual fund industry operates in an increasingly global marketplace where adherence to world standards will be central to its continued success.

## Our thesis

In recent years, a number of voices have called for improved mutual fund governance and other changes to the way we regulate mutual funds in Canada. This concept proposal underscores our agreement with earlier commentators that a well-defined fund governance system—one that

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<sup>1</sup> *Regulatory Strategies for the Mid-'90s: Recommendations for Regulating Investment Funds in Canada*, prepared by Glorianne Stromberg for the Canadian Securities Administrators, January 1995.

<sup>2</sup> During a luncheon address at the 2001 Dialogue with the OSC, Randall Powley, Chief Economist of the Ontario Securities Commission, explained that “while the percentage of Canadians entering the publicly traded markets may be close to a peak, the funds committed to those markets should triple or quadruple in the next 10-15 years.... As the urgency to ensure the integrity of retirement savings increases with the looming of boomer retirement, the quality of advice will come under increasing pressure”.

relies on increased scrutiny of fund managers by independent groups charged with looking after investors' best interests—is a desirable thing.

But while we accept the need for improved fund governance, we are not interested in simply layering new regulation on top of old. We think it is important to understand the goals of fund governance and where they fit within the broader context of mutual fund regulation. The result is a proposal that goes beyond simply recommending fund boards. This concept proposal describes a renewed framework for regulating mutual funds and their managers that is congruous and comprehensive yet flexible and tailored to suit the Canadian mutual fund industry.

### **Our desire for an informed dialogue**

We launched the current foray into regulatory reform by asking Stephen Erlichman, a senior partner of Fasken Martineau DuMoulin LLP in Toronto, to provide us with a summary of the fund governance discussion in Canada and abroad and to make specific recommendations to improve fund governance. We released his report entitled *Making it Mutual: Aligning the Interests of Investors and Managers: Recommendations for a Mutual Fund Governance Regime for Canada* during the summer of 2000 to generally further the discussion on this subject and to elicit further comment.<sup>3</sup>

Since we released Mr. Erlichman's report, we have consulted widely on the topic of fund governance with industry participants, their legal and accounting advisers, legal scholars, and international mutual fund regulators. At the same time, we took this opportunity to learn more about the industry and its practices.

### **The background reports: our empirical and legal research**

We began our empirical research by reviewing what mutual funds say about their governance practices in their annual information forms (a required disclosure item since February 1, 2000). We then held face-to-face interviews with more than a third of the mutual fund managers across Canada, travelling from Québec to British Columbia. Finally, we sent an electronic survey to each fund manager with fund governance experience and worked to obtain a 100 percent response rate. We are satisfied that our research has given us additional insight on the business realities of the Canadian mutual fund industry. Staff of the Ontario Securities Commission (the OSC) have summarized this research in a background paper to this concept proposal entitled *The Canadian Mutual Fund Industry: Its Experience With and Attitudes Toward Mutual Fund Regulation: A Background Research Report to Concept Proposal 81-402 of the Canadian Securities Administrators*. We refer to this background paper as the staff research paper.

Our understanding of the mutual fund business is complemented by our research into the legal environment mutual fund managers operate in. We know that most mutual funds in Canada are structured as trusts, therefore we retained David Stevens, a trust law expert with Goodman and Carr LLP in Toronto. Mr. Stevens has prepared a second background paper to this concept proposal entitled *Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance Structures*. In this paper, Mr. Stevens analyses the private law context in which mutual funds currently operate and suggests ways in which a fund governance regime can be

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<sup>3</sup> *Making it Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada*  
Prepared for the Canadian Securities Administrators by Stephen I. Erlichman, Senior Partner, Fasken Martineau DuMoulin LLP, June 2000.

created using that body of law. We refer to this background paper as the Stevens legal research paper.

## Thank you

We appreciate the many industry participants—including the members of the Fund Governance Committee of the Investment Funds Institute of Canada—who have generously shared their time and thoughts with us.

### The background to this concept proposal

These are the main sources we consulted when developing our proposals:

On mutual funds and mutual fund governance:

- *Making it Mutual: Aligning the Interests of Investors and Managers – Recommendations for a Mutual Fund Governance Regime for Canada*, prepared for the Canadian Securities Administrators by Stephen I. Erlichman, June 2000
- *Regulatory Strategies for the Mid-'90s – Recommendations for Regulating Investment Funds in Canada*, prepared by Glorianne Stromberg for the Canadian Securities Administrators, January 1995
- *Investment Funds in Canada and Consumer Protection: Strategies for the Millennium* by Glorianne Stromberg, October 1998
- *The Stromberg Report: An Industry Perspective*, prepared by the Investment Funds Steering Group for the Canadian Securities Administrators, November 1996
- *The Modernization of the Normative Framework in the Québec Context*, prepared by the Consultative Committee on the Regulation of Mutual Funds, January 1997
- *Report of the Canadian Committee on Mutual Funds and Investment Contracts – Provincial and Federal Study, 1969*, Queen's Printer, 1969
- *The Governance Practices of Institutional Investors*, by the Standing Senate Committee on Banking, Trade and Commerce, November 1998
- *Regulating Conflicts of Interest in the Management of Mutual Funds: the Current Regime*, Report by staff of the Ontario Securities Commission, March 1995
- *Assessing Risks & Controls of Investment Funds, Guidance for Directors, Auditors and Regulators*, A Research Report by The Canadian Institute of Chartered Accountants, October 1999

On corporate governance:

- *Where were the Directors? Guidelines for Improved Corporate Governance in Canada*, Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada, December 1994 (the Dey Report)
- *Report on Corporate Governance, 1999 Five Years to the Dey*, Toronto Stock Exchange, 1999
- *Beyond Compliance: Building a Governance Culture*, Final Report of the Joint Committee on Corporate Governance, November 2001 (the Saucier Report)

On international perspectives:

The following reports by the Technical Committee of the Organization of International Securities Commissions (IOSCO) on collective investment scheme (mutual fund) regulation are available on the IOSCO website at [www.iosco.org](http://www.iosco.org).

- *Report on Investment Management – Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum* July 1995
- *Objectives and Principles of Securities Regulation* September 1998
- *Summary of Responses to Questionnaire on Principles and Best Practices Standards on Infrastructure for Decision Making for CIS Operators* May 2000
- *Conflicts of Interest of CIS Operators* May 2000
- *Delegation of Functions* December 2000

## Your comments

We are keen to have your input. We believe an open dialogue with the industry and consumers is necessary if we are to fashion an effective regulatory regime for mutual funds and their managers. We have raised specific issues for you to comment on in shadowboxes (such as this one) throughout this paper. We also welcome your comments on other aspects of the concept proposal, including our general approach and anything that might be missing from it.

Comments are due by June 7, 2002 and should be sent to the CSA care of:

John Stevenson, Secretary  
Ontario Securities Commission  
20 Queen Street West  
19<sup>th</sup> floor, Box 55  
Toronto, ON, M5H 3S8  
Telephone: 416-593-8145  
Fax: 416-593-2318  
e-mail: [jstevenson@osc.gov.on.ca](mailto:jstevenson@osc.gov.on.ca)

and

Denise Brousseau, Secretary  
Commission des valeurs mobilières du Québec  
800 Victoria Square, Stock Exchange Tower  
P.O. Box 246, 22<sup>nd</sup> Floor  
Montreal, Québec H4Z 1G3  
Telephone: 514-940-2150  
Fax: 514-864-6381  
e-mail: [consultation-en-cours@cvmq.com](mailto:consultation-en-cours@cvmq.com)

If you are not sending your comments by e-mail, please send us two copies of your letter, together with a diskette containing your comments (in either Word or WordPerfect format). We cannot keep submissions confidential because securities legislation in certain provinces requires us to publish a summary of written comments received during the comment period.

## How to read this paper

### Plain language

We wrote this concept proposal in plain language to make it understandable by a broad audience. To ease your review of our proposals, we have not quoted from background sources, although we cite them where relevant. We have assumed that most readers are already familiar with much of the background discussion on mutual fund governance.

### Numbering

Our recommendations are presented in numbered paragraphs for ease of reference.

### Text boxes

The text boxes (such as this one) throughout the paper include information that may be of interest to readers, such as:

- background or explanatory information; and
- alternatives to the proposals we are forwarding.

### Background reports

We are publishing this concept proposal together with two background papers:

- *The Canadian Mutual Fund Industry: Its Experience With and Attitudes Toward Mutual Fund Regulation: A Background Research Paper to Concept Proposal 81-402 of the Canadian Securities Administrators*, prepared by staff of the Ontario Securities Commission; and
- *Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance Structures*, prepared by David Stevens of Goodman and Carr LLP, Toronto.

Readers seeking more information on the legal backdrop and analysis or the empirical research supporting this concept proposal are referred to these background papers. They are available on the Ontario Securities Commission website at [www.osc.gov.on.ca](http://www.osc.gov.on.ca) and also on the websites of other provincial regulators, the British Columbia Securities Commission at [www.bcsc.bc.ca](http://www.bcsc.bc.ca), the Alberta Securities Commission at [www.albertasecurities.com](http://www.albertasecurities.com). French translations of the concept proposal and the staff research paper are available on the website of the Commission des valeurs mobilières du Québec at [www.cvmq.com](http://www.cvmq.com).

You can also call 1-877-785-1555 toll-free to ask a member of the OSC's Contact Centre to mail these background reports to you. The OSC's Contact Centre can also tell you how you can get copies of many of the background reports we list in the text box above.

## A. Our vision for mutual fund regulation

As the mutual fund industry in Canada has grown and matured, there has been a corresponding evolution in our understanding of mutual fund regulation. Mutual fund regulation can no longer be seen as an addendum to, or a variation on, the larger body of securities legislation; instead, it must be understood on its own terms. Rather than simply adding to existing regulation, we believe it is important to consider a renewed framework for regulating mutual funds and their managers. Such a comprehensive framework will ensure that this and future proposals for regulatory reform work towards a coherent end.

### Our proposed framework compared to the current regime

We propose a renewed framework for regulating mutual funds and their managers that will rest on five pillars.

- I. Registration for mutual fund managers
- II. Mutual fund governance
- III. Product regulation
- IV. Disclosure and investor rights
- V. Regulatory presence

Some of these pillars are already firmly ensconced within our existing regulation while others are only partially built, or not present at all. The following table compares and contrasts the current regime with our proposed framework.

| <b>Current Regime</b>  | <b>Proposed Framework</b>  |
|--|--|
| <p><b>Mutual fund managers are not registered as such</b></p> <p>Mutual fund managers are only registered with securities commissions if they trade in fund securities (acting as dealers) or manage the assets of individual funds (acting as advisers/portfolio managers). Some mutual fund managers are not registered at all because they do not themselves carry on the activities that we currently regulate. The registration requirements for dealers and advisers are not tailored to mutual fund managers.</p> | <p><b>A new registration category for mutual fund managers</b></p> <p>We will regulate who can act as a mutual fund manager by creating a new registration category, with tailored conditions of registration, for mutual fund managers. New minimum standards will be imposed on mutual fund managers through conditions of registration that are designed for the business of managing mutual funds.</p> |

| Current Regime   | Proposed Framework  |
|--|---|
| <p><b>No independent oversight of the mutual fund manager and a conflicts regime based on prohibitions</b></p> <p>The current regulation does not mandate independent oversight of the mutual fund manager.</p> <p>However, mutual fund managers are bound by a standard of care set out in certain provincial securities legislation. In Ontario, for example, mutual fund managers must exercise their responsibilities honestly, in good faith and in the best interests of the mutual fund and must exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.<sup>4</sup> Mutual fund managers are also accountable under our rules for the actions of service providers to the funds.</p> <p>Securities legislation of some provinces, for example Part XXI of the <i>Securities Act</i> (Ontario), regulates conflicts of interest by prohibiting certain transactions between related parties associated with mutual funds.<sup>5</sup></p> <p><b>Detailed product regulation for mutual funds</b></p> <p>We regulate the structure and operation of mutual funds through National Instrument 81-102 Mutual Funds which sets out detailed rules on areas such as:</p> <ul style="list-style-type: none"> <li>▪ investment restrictions and practices,</li> <li>▪ seed capital for new mutual funds,</li> <li>▪ custodianship of fund assets,</li> <li>▪ sales and redemption procedures,</li> <li>▪ calculations of net asset value.</li> </ul> <p>Other securities regulation also applies to mutual funds.</p> | <p><b>A new fund governance regime to ensure independent oversight of mutual fund managers and to minimize conflicts of interest</b></p> <p>A group that is independent of the mutual fund manager, called a governance agency, will oversee that manager's management of its mutual funds. This governance agency will owe its allegiance to investors and will ensure that the mutual fund manager acts in the best interests of investors.</p> <p>Mutual fund managers will continue to be bound by a standard of care that requires them to act in the best interests of the mutual fund. They will also continue to be responsible for the actions of service providers.</p> <p>Mandated fund governance will allow us to move from a transactional, prohibition based approach to regulating conflicts of interest to one that relies on oversight by independent governance agencies.</p> <p><b>Streamlined product regulation for mutual funds</b></p> <p>We will continue to regulate the structure and operation of mutual funds in much the same way we do today; however, we will be re-evaluating each of the detailed rules currently contained in National Instrument 81-102 Mutual Funds, as well as other applicable securities regulation. Where it is warranted, these rules will be eliminated or will be replaced by broader regulatory principles or guidelines and a requirement that each independent governance agency monitor how these are met by each fund manager.</p> |

<sup>4</sup> Section 116 of the *Securities Act* (Ontario). Also see section 157 of the *Securities Act* (Alberta), section 125 of the *Securities Act* (British Columbia), section 124 of the *Securities Act* (Nova Scotia) and section 25 of the *Securities Act* (Saskatchewan). Section 235 of the Regulation made under the *Securities Act* (Québec) imposes a similar standard of care on “registered persons”, including dealers and portfolio managers.

<sup>5</sup> The following provinces also have conflict provisions in their legislation: Alberta, British Columbia, Nova Scotia, Saskatchewan and Québec.



| Current Regime  | Proposed Framework   |
|---|--|
| <p><b>Disclosure and investor rights</b></p> <p>Mutual funds must give investors certain information in a prospectus at the time they invest and continuous disclosure documents for so long as they remain invested. National Instrument 81-101 Mutual Fund Prospectus Disclosure sets a national standard for mutual fund prospectuses. Provincial securities legislation regulates continuous disclosure requirements. Mutual fund managers are accountable under securities legislation to investors for the information in their mutual funds' prospectuses.</p> <p>Investors have rights to vote on any fundamental changes proposed to their mutual fund as set out in National Instrument 81-102 Mutual Funds.</p> <p>Sales communications are regulated by National Instrument 81-102 Mutual Funds.</p> <p><b>Regulatory presence</b></p> <p>Members of the CSA that are mutual fund jurisdictions (principal regulators for mutual fund filings) look for compliance with their legislation primarily by reviewing prospectuses.</p> <p>Some CSA members, notably the Ontario Securities Commission, are increasingly conducting on-site compliance examinations.<sup>6</sup></p> <p>Enforcement actions are taken where warranted.</p> | <p><b>Continued disclosure and investor rights</b></p> <p>Investors will continue to receive a prospectus at the time they invest and continuous disclosure documents for so long as they remain invested in a mutual fund. It is important to remember that if we simplify product regulation, disclosure to investors on the specifics of their investments becomes even more crucial.</p> <p>Investors will continue to have rights in the face of fundamental changes, but we will re-examine how investor rights fit in with fund governance.</p> <p>We will continue to regulate sales communications.</p> <p><b>Enhanced regulatory presence</b></p> <p>Principal regulators of mutual funds will enforce compliance with regulation through desk reviews of prospectus, continuous disclosure, and sales communication documents.</p> <p>On-site compliance examinations of mutual fund managers will increase.</p> <p>Enforcement actions will be taken if warranted.</p> |

## The underlying shift in our approach to mutual fund regulation

### A shift in emphasis from the mutual fund to the mutual fund manager

We currently take a hybrid approach to regulating mutual funds and their managers. On the one hand, we regulate mutual funds via the general body of securities legislation, which has been modified to suit the mutual fund context. On the other hand, we have developed a body of specialized rules reflecting the unique nature of mutual funds, their management, and their distribution structures.

<sup>6</sup> The following provincial regulators also conduct on-site compliance examinations of mutual fund managers that are registered as investment counsel/portfolio manager and mutual fund dealers: Alberta, British Columbia, Québec and New Brunswick. Manitoba intends to commence these in 2002. Ontario conducts examinations of non-registered mutual fund managers.

The portion of our regulation that is derived from general securities legislation rests on the underlying assumption that mutual funds are simple issuers of securities and that investors buy mutual fund securities in much the same way as they buy corporate securities. These assumptions led securities regulators to treat mutual funds as “reporting issuers” of securities and as though they were public corporations.

In contrast, our specialized product regulation grew up to ensure retail investors are offered a safe and reliable investment vehicle. The central feature of mutual funds is that they are redeemable on demand and much of the regulation operates to ensure that this feature can be met. Also, since mutual funds are investment vehicles essentially designed for mass distribution to retail investors, product regulation is designed to ensure consistency in the product.

The emphasis in our current regulation is placed squarely on the mutual fund itself as an issuer of securities. The mutual fund manager and its management of its mutual funds is less important. Without an emphasis on regulating fund managers or the overall management relationships, regulation of the structure of a mutual fund as a reporting issuer is critical.

We believe our current regulation, with its relative lack of emphasis on mutual fund managers, does not reflect the commercial realities of mutual fund management or investing. When mutual fund investors put their money in a mutual fund, they are purchasing the skill of that fund’s manager as much as they are purchasing a security. Mutual funds are much more than free-standing issuers or products that exist independently of the mutual fund manager that creates and operates them. If mutual fund regulation is to more accurately reflect this commercial reality, we believe it must place greater emphasis on mutual fund managers and their activities.

## **Why our proposed framework will strike a better balance than the current regime**

### **The current regulatory approach to conflicts of interest**

As the Stevens legal research paper and other background reports explain, conflicts of interest are inherent in most mutual fund structures.<sup>7</sup> The investor’s “ownership” of a mutual fund is separate from the fund manager’s management and control of that mutual fund. Hence, the potential exists for the interests of investors to diverge from the interests of the fund manager. The potential that the self-interest of mutual fund managers will conflict with the interests of investors is further exacerbated by the power imbalance between mutual fund managers and investors. The reality is that Canadian investors have neither the resources nor the inclination to effectively oversee the managers of their mutual funds.

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<sup>7</sup> See the Stevens legal research paper; *Regulatory Strategies for the Mid-'90s – Recommendations for Regulating Investment Funds in Canada*, prepared by Glorianne Stromberg for the Canadian Securities Administrators, January 1995; *Regulating Conflicts of Interest in the Management of Mutual Funds: the Current Regime*, report of staff of the Ontario Securities Commission, March 1995; and the paper by the Technical Committee of IOSCO, *Conflicts of Interest of CIS Operators* May 2000 for a detailed description of the different types of conflict that may arise in the mutual fund context. These publications also discuss the reasons for regulating conflicts.

Regulators seek to alleviate the potential for abuse that arises from the realities we describe. Regulating these conflicts of interest is a priority for mutual fund regulators, both in Canada and internationally. As a recent paper by the Organization for Economic Co-operation and Development (OECD) explains, there are at least two approaches to regulating conflicts in the mutual fund context:<sup>8</sup>

One approach to possible conflicts of interest would be for CIS [collective investment scheme or mutual fund] regulators to impose highly restrictive rules and wide-ranging prohibitions.... Most analysts believe that this approach would be excessively rigid. Instead most countries have created well-defined but flexible governance frameworks consisting of two parts: 1) accepted standards of conduct that combine official rules and industry best practice; and 2) well-defined legal and regulatory environments for CIS in which certain designated parties are charged with scrutinizing the activity of the CIS for conformity with those standards.

While most jurisdictions have opted for an approach based on independent oversight of the mutual fund manager, Canadian regulators have to date responded to potential conflicts of interest by simply prohibiting certain relationships or transactions by mutual fund managers.<sup>9</sup>

### **Criticisms of our current regulatory approach**

Although our prohibition-based approach to regulating conflicts of interest may be a straightforward way to avoid abuses, we recognize its shortcomings. We know that the current approach is too restrictive on the one hand—because it prohibits transactions that are innocuous or even beneficial to investors—and not inclusive enough on the other—because it only deals with certain specific transactions. We recognize that we cannot say that we have achieved a complete prohibition against all potential conflicts of interest. For example, our regulation does not address:

- cost allocations between fund managers and the mutual funds they manage,
- the expenses a fund manager can charge to its mutual funds,
- proxy voting, or
- the allocation of assets amongst funds and the fund manager.

We also must acknowledge that, as regulators, we often do not have the necessary insight into a fund manager's business to know when to give discretionary relief from our prohibitions.

### **Benefits of our proposed framework**

As we explained above, we are shifting our regulatory focus from the mutual fund itself to the mutual fund manager, its relationships, and activities. Conflicts of interest under our proposed framework would be regulated through a governance regime rather than restrictive rules and wide-ranging prohibitions. Improved mutual fund governance represents a structural solution to

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<sup>8</sup> *Governance Systems for Collective Investment Schemes in OECD Countries* by John K. Thompson and Sang-Mok Choi of the Directorate for the Financial, Fiscal and Enterprise Affairs, Financial Affairs Division Occasional Paper, No.1, April 2001 at 10.

<sup>9</sup> Although regulators have been given broad discretion to grant relief from those prohibitions, this discretion generally is exercised in narrow circumstances.

the inherent conflicts, it avoids the criticisms of our current regime, and it offers the following benefits:

*Simplicity and flexibility.* Our proposed approach to mutual fund regulation will streamline mutual fund regulation by replacing detailed rules with broader principles. It will also be flexible enough to keep pace with continuing changes to our maturing mutual fund industry. We believe the proposed approach may prevent problems from occurring and will enhance investor protection through bolstering fund manager responsibility and accountability.

*Consistency with global standards.* As the OECD paper highlights, Canada is one of the few remaining countries in the world that does not mandate some form of independent mutual fund governance. For this reason, Canadian mutual fund regulation is considered to be incomplete by some international regulators and industry participants. Reforming our mutual fund regulation to make it consistent with global regulatory standards will improve the Canadian industry's reputation as a well regulated and governed industry and may afford Canadian mutual funds easier access to international markets where foreign mutual funds are allowed entry, such as Hong Kong.

*Consistency within the industry.* In the absence of a fund governance regime, various industry practices have grown up to ensure that mutual fund managers remain accountable to investors. Some managers have independent governance and written policies and procedures while others ask individuals associated with the manager to oversee their activities and many managers have no governance procedures at all. The proposed approach will bring consistency to the industry by requiring all managers to formally account for their actions and will impose a single standard across the country.

Through our renewed framework we expect to achieve a more balanced approach to regulation—one that will seek to alleviate potential abuses that might arise from conflicts of interest and that will address the asymmetry inherent in mutual fund investing. Our new regulation will be designed to be proactive and will emphasize the responsibilities of industry participants.

## Are there alternatives?

Although this concept proposal sets out specific regulatory proposals, we considered other alternatives, including alternatives suggested to us by the industry (these are outlined in the staff research paper). The primary alternatives we considered are described here. We invite your comments on these, and any other alternatives.

### Alternative 1 – A non-regulatory approach

We considered whether it would be possible to improve fund governance across Canada without imposing a comprehensive body of new rules. Under a non-regulatory approach, we would encourage the Investment Funds Institute of Canada (IFIC), the trade association for the investment funds industry in Canada, to produce a set of best practice guidelines for fund governance that its members would adopt voluntarily. We would amend our disclosure rules to require mutual funds to compare their governance practices against these industry best practices. A mutual fund would undertake this comparison annually in conjunction with its annual prospectus renewal.

This approach has parallels in recent Canadian corporate governance developments—the Dey Report and now the Saucier Report advocate in favour of voluntary guidelines coupled with disclosure.

This approach would put investors in a position to consider a mutual fund's governance practices in their assessment of the fund. If investors come to believe that mutual fund governance is an important part of their investment decision, they will demand that mutual funds explain any material variations between their actual practice and the guidelines. Their ensuing investment decisions would bring competitive pressure to bear on the industry to adopt good governance practices. This approach is based on the theory that market dynamics would determine whether the benefits of independent governance would exceed the costs.

Under this approach we would re-examine our existing product regulation in a manner consistent with Part III and IV of this concept proposal.

Under this non-regulatory approach, we would not develop a specialized registration regime for mutual fund managers. We would consider, on a case by case basis, how we would deal with any fund managers who are not already registered with us as dealers or advisers.

We ask you to consider this alternative in light of the following:

- While the Dey Report guidelines for good corporate governance build on a well-established body of corporate law and practice (one that includes a basic requirement for a board of directors with defined duties and responsibilities), voluntary guidelines for mutual fund governance would have no such legal underpinning to support it. The core fund governance concepts—particularly the requirement that there be an independent fund governance agency, with a majority of independent members subject to a standard of care—would not have the force of law. Members of a governance agency would have no clarity on their legal responsibilities and duties.
- This alternative assumes that mutual fund investors will read and understand fund governance disclosure and vote with their feet if they disagree with the approach taken. The Dey Report approach to corporate governance is consistent with the overall regulatory approach to public corporations. Investors in public corporations can rely on institutional investors and analysts to read and analyse the material. Information about the governance of public companies is, in this fashion “public” in a way that has no parallel in the mutual fund context.
- Mutual funds are complex products offered by a complex industry. Much of our current mutual fund regulation is designed to bring consistency and clarity to investors and industry participants. Industry governance guidelines that need not be adopted or that may be adapted to suit a fund complex would not necessarily result in consistency or uniform safeguards or improved fund governance.

### **Alternative 2 – Reliance on enhanced duties for auditors or an enhanced role for the regulator**

We considered whether the auditors of mutual funds or the regulators could play a greater role in overseeing management of mutual funds. Although we agree that auditors can provide opinions on aspects of good governance, broadly defined, we do not believe the audit function can be a substitute for good governance practices. The discretion necessary for decision-making in this area must rest with a body such as a governance agency and cannot be shifted to the auditors. As regulators we cannot effectively oversee the business of individual fund managers to the same extent as independent governance agencies, although we do propose to enhance our regulatory presence as part of our renewed framework.

### **Alternative 3 – Require fund managers to create an independent governance agency, but allow them complete freedom to determine its structure, roles and responsibilities**

We also considered whether we should give each mutual fund manager the freedom to design its own governance agency as it sees fit. While this approach would provide some measure of independent oversight while providing the mutual fund industry with more flexibility, we are not convinced this approach would achieve our objectives in reforming our regulation. Too much flexibility would likely lead to a diversity of approaches and a lack of rigor in the oversight provided by these governance agencies. It is difficult to argue for changes in our product regulation and conflicts of interest provisions unless we articulate what we expect from each governance agency.

### **Alternative 4 – Require fund managers to create an independent governance agency, but do not require fund managers to be registered nor define minimum standards for fund managers**

We discuss this alternative in the section of this concept proposal that deals with the registration of mutual fund managers. We outline why we have not accepted this alternative at that juncture.

### **Issues for comment**

01. We see our renewed framework for regulating mutual funds as a step towards a more flexible regulatory approach, one that represents a movement away from detailed and prescriptive regulation. By streamlining our regulation, we want to create a regulatory regime that can accommodate changes within the industry and keep pace with changes in other segments of the market and global market places. What are your views on our renewed framework? Will it represent an improvement over our current model?
02. After reading the staff research paper and the text box above, what is your opinion about the alternatives to our proposed approach? If you believe we should not change the status quo, please explain why. If you favour one or more of the alternatives we set out, please explain why. Are there other alternatives that we should consider?

## How our proposed framework relates to the regulation of other investment products

This concept proposal describes a renewed framework for regulating *mutual funds*. We use this term to cover the large sub-set of investment funds that are:

- sold continuously to the public by a prospectus
- redeemable on demand on a daily or weekly basis
- regulated through National Instrument 81-102 Mutual Funds
- commonly referred to as “mutual funds”.

Commodity pools are specialized mutual funds. In some provinces, labour sponsored investment funds are regulated as mutual funds.<sup>10</sup>

We know that as we move forward, we must keep in mind the broader continuum of investment vehicles that we do not regulate as mutual funds. This continuum includes:

- pooled funds, including hedge funds, that are sold to investors under an exemption from prospectus requirements
- segregated funds, offered by insurance companies, that are regulated under insurance legislation by insurance regulators
- exchange-traded funds listed on stock exchanges
- quasi closed end funds, redeemable only a periodic basis, usually quarterly or semi-annually
- closed end funds listed on stock exchanges.

We believe our proposals should not create different regulatory schemes for substantially similar investment vehicles. Like products should be regulated in a like manner. The challenge is to identify which products are substantially similar in ways that justify our regulating them using similar regulatory principles and tools.

Through our participation in the Joint Forum of Financial Market Regulators,<sup>11</sup> we are working to harmonize the regulation of mutual funds and segregated funds. We and our insurance regulator colleagues recognize the similarities between these two investment vehicles. In December 1999, the Joint Forum published a description of the fifteen areas where work is needed to achieve harmonization.<sup>12</sup> Governance and the regulation of fund managers (or insurance companies, in a segregated fund context) are two areas where the Joint Forum thinks harmonization is necessary.

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<sup>10</sup> For example, Ontario, Saskatchewan and Manitoba regulate labour sponsored investment funds as mutual funds.

<sup>11</sup> The Joint Forum of Financial Market Regulators is a group made up of representatives of the CSA, the Canadian Council of Insurance Regulators and the Canadian Association of Pension Supervisory Authorities.

<sup>12</sup> *Recommendations for Changes in the Regulation of Mutual Funds and Individual Variable Insurance Contracts* Joint Forum of Financial Market Regulators December 15, 1999 published in the Bulletin of the Ontario Securities Commission at (1999) 28 OSCB 50

As we move forward with our renewed framework for the regulation of mutual funds, we will be working towards meeting the challenge of determining which aspects of mutual fund regulation, if any, should also be applied to other investment vehicles.

### **Issues for comment**

03. Do you agree that labour sponsored investment funds (where applicable) and commodity pools should be subject to the same regulatory scheme as other mutual funds (considering the specialized rules that we already have for these specialized mutual funds)? If not, why?
04. Which parts of our renewed regulatory framework should be extended or not extended to other investment vehicles—and which investment vehicles? Why do you believe the particular regulation should or should not be extended? What is the essential difference—or similarity—between the particular investment vehicles that mean they should be regulated differently or the same?



## B. The proposals

We recognize that a move from our current regime to the five pillared framework for regulating mutual funds and their managers will require far-reaching reform. This concept proposal maps out what we need to do to bring our new framework into being.

We set out two new regimes for regulating mutual fund managers and their activities in the form of the following pillars:

- I. registration of mutual fund managers
- II. mutual fund governance

Although registration is the first pillar in our framework, we have chosen to treat mutual fund governance before registration due to the far-reaching implications of our proposals in this area.

Once we outline the two new regimes for regulating mutual fund managers, we then outline our plans to re-evaluate and refine the following parts of our existing regulation to eliminate any redundancies that may result from the addition of new regulation:

- III. the existing product regulation contained in National Instrument 81-102 Mutual Funds and conflicts of interest regulation contained in securities legislation
- IV. the investor rights regime.

The fifth pillar—an enhanced regulatory presence—is not addressed in this paper.

### **Issues for comment**

- 05. Although we do not address the fifth pillar of our proposed framework, we invite you to give us your ideas on how we could better carry out our role as regulator.

# I. Mutual fund governance

This part of the concept proposal explains how we propose to improve fund governance in Canada by requiring independent monitors to oversee the activities of mutual fund managers. This oversight is intended to ensure that mutual fund managers comply with the required standard of care and act in the best interests of investors.

## What is mutual fund governance?

It is incorrect to say that we propose to introduce mutual fund governance to the industry—as our previous discussion alluded, mutual funds in Canada are already subject to many forms of governance. Instead, we believe we will *improve* mutual fund governance by ensuring that all aspects of accepted good governance are covered.

Good governance for mutual funds requires:

- accepted standards of conduct for industry participants
- accountability of industry participants to investors
- relevant and timely information to investors and market places
- fundamental rights for investors
- independent monitoring and oversight by a group acting as a proxy for investors.

Our current regulation prescribes all of the above requirements, except for the last—independent monitoring and oversight.

## Issues for comment

06. As you read this section of the concept proposal, please consider whether you believe our approach will result in mutual funds being monitored by a governance agency that:

- a. effectively oversees the management of the mutual funds
- b. has real powers and real teeth and
- c. adds value for investors.

If you agree or disagree that our proposals will meet these goals, please tell us why. What do we need to change in order to achieve them?

07 We kept Canadian corporate governance practices in mind as we developed our proposals. Have we omitted an important principle of corporate governance that you think should apply to mutual fund governance?

## 1.1 The governance agency concept

1. A governing body that is independent of the mutual fund manager will supervise that manager's management of its funds and will act to ensure those mutual funds are managed in the best interests of investors. This governing body will act solely in the best interests of investors and will be largely free from conflicts of interest. We refer to this independent governing body throughout this concept proposal as a "governance agency."
2. Each governance agency will be established, and will act, according to the 10 broad governance principles outlined below. The key principles governing its design are that it be sufficiently independent of the fund manager so that conflicts of interest are minimized and that it have sufficient powers and duties to be an effective monitor.
3. Mutual fund managers will be allowed to structure mutual funds much as they do now. Each mutual fund manager will decide how to integrate the governance agency into its own fund structure.

Thus, for a mutual fund structured as a corporation, its board of directors will be that fund's governance agency. For mutual funds structured as trusts, any of the following would qualify as the governance agency:

- a board of individual trustees
- a registered trust company (however if it is related to the fund manager, its board of directors must have a majority of members who are independent of the fund manager, the trust company and their respective shareholders) or
- a board of governors interposed between the trustee of the mutual fund and the fund manager (for example, this approach could be used where the fund manager acts as trustee).

However, the governance agency for a mutual fund trust could not be the board of directors or a committee of the board of directors of the mutual fund manager or the shareholder(s) of the mutual fund manager since those directors already owe an allegiance to their shareholders. We do not consider this form of governance agency to be independent from the mutual fund manager or its shareholders.

4. "Owner-operated" mutual funds do not raise the same conflict of interest concerns as other mutual funds. Owner-operated mutual funds are funds sold exclusively to defined groups of investors, such as members of a trade or professional association or co-operative organization, who, directly or indirectly, own the fund manager. We believe the interests of the fund manager and investors in the mutual fund are aligned in an owner-operated structure. Accordingly we will allow the board of directors of a fund manager of an owner-operated mutual fund or its shareholder(s) to act as the governance agency for these mutual funds.

## **A flexible approach to fund governance**

Our background research, both empirical and legal, has led us to conclude that we do not need to mandate any one formal legal structure for a governance agency, so long as we establish the basic governance principles to be followed by it.

Our empirical research tells us that mutual funds in Canada are a diverse lot. They are structured and governed in a multitude of ways. Some mutual funds already have a governance agency in place. Our proposals take into account both the legal and practical realities of the Canadian mutual fund industry.

David Stevens has told us that a mutual fund is basically a contract, therefore freedom of contract prevails. He has also told us that the private law that applies to mutual funds is quite flexible. Based on Mr. Stevens' assessment, we have concluded that industry participants can legally create the governance agency we contemplate in different ways.

The Stevens legal research paper poses two central questions about the implementation of our proposals:

1. "...how as a matter of legal form or structure can a governance agency be imposed on the great variety of mutual fund structures that currently exist?
2. what precisely should the content of the governance powers and responsibilities be?"

The first question is answered in the Stevens legal research paper. We address the second question in the next part of this concept proposal.

## **Will our flexible approach work in Québec?**

Trusts in Québec are governed by the Québec Civil Code. We understand that we must ensure that our proposals will work under the civil law of that province in ways that are comparable to the common law that applies in the rest of Canada. For this reason, we asked David Stevens to examine the implications of the Québec Civil Code for our proposals in his background paper. Mr. Stevens concludes that there is no legal reason, as a matter of civil law, why our proposed regulatory approach to fund governance cannot work for mutual funds subject to that law.

## **Issues for comment**

08. Having read the Stevens legal research paper, do you believe a flexible approach to fund governance is preferable to a single legal model, such as a board of trustees for all mutual fund trusts? Why or why not? Do you see any practical difficulties with the legal options presented in that paper? Are there any other options we should consider? Do you agree with the analysis of Québec civil law?
09. David Stevens writes about structural and situational conflicts in a mutual fund context. Do you agree with David Stevens' description of the conflicts? We agree with him that serious conflicts arise when the boards of directors of a fund manager or its shareholder(s) propose to act as the governance agency for a mutual fund and we propose to prohibit this. Do you agree with this conclusion? Please explain your answer.
10. Do you agree with our proposals and our analysis of owner-operated mutual funds? If not, please explain.

## **1.2 The governance principles**

### **1. Each manager will establish a governance agency**

Each mutual fund family will establish at least one governance agency to oversee the mutual fund manager's management of its funds. A mutual fund manager may decide to establish more than one governance agency to oversee its management of its mutual funds, that is, it may create a governance agency for each of its mutual funds or groups of related mutual funds as it sees fit.

#### **Issues for comment**

11. We do not currently propose to specify the maximum number of mutual funds that may be overseen by a governance agency. Is there a practical limit to the number of mutual funds that one governance agency can oversee effectively? Are mutual funds managed in ways that are sufficiently common to all mutual funds so that one governance agency can oversee all mutual funds in a related family? Should we provide guidance to the industry on the scope of oversight for a governance agency?

### **2. The governance agency will be of a sufficient size**

The governance agency for a mutual fund family will have no fewer than three individual members. When the fund manager is setting up the first governance agency, the fund manager should consider the size of the governance agency to ensure that it has enough members to discharge its responsibilities. Thereafter, the governance agency will consider its size, based on its experience with performing its duties. If additional members are needed, the governance committee should appoint them.

### **3. Governance agency members will be independent**

A majority of the governance agency members will be independent of the mutual fund manager. An independent member will act as the governance agency chair.

## **Two issues about independence of members:**

### **A definition of independence**

Stephen Erlichman recommends that we base our definition of independence on the Dey Report's definition of "unrelated directors". We agree with this recommendation. Thus, a member of a governance agency of a mutual fund will be independent of the fund manager if he or she is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially influence the member's oversight of the mutual fund manager's management of the mutual fund. Governance agency members will be required to be independent of the fund manager, its management, and its major shareholders and any party that is in a position to exert influence upon management of the fund manager.

### **A majority versus all members being independent**

Since the primary purpose of the governance agency is to ensure that conflicts of interest in the management of mutual funds are minimized, some people have suggested to us that all members of the governance agency should be independent. Why should some members be related to the fund manager? In a corporate context, we accept the need for some directors to have a connection to the management of the corporation. In a mutual fund context, what role do the non-independent members of the governance agency play? Notwithstanding the arguments in favour of requiring all members of a mutual fund governance agency to be independent, we believe that equally valid reasons exist for fund manager representatives to be members of a governance agency. These representatives will be expected to bring the perspective of the fund manager to the governance agency, including their insights into the business of the fund manager.

## **Issues for comment**

12. Do you think fund families will find it difficult to recruit qualified members for a governance agency at a reasonable cost? Do you have any experience with trying to recruit members of a governance agency?
13. Does the definition of independent members make sense to you? Will it be easy to apply to potential governance agency members? If not, can you suggest an alternate definition or the clarifications you think are necessary? What do you think about whether or not we should require a majority or all members to be independent?

## **4. The role of the governance agency will be to oversee**

The role of a governance agency will be to oversee actions of the mutual fund manager in managing its mutual funds to see that it acts in the best interests of investors. The governance agency's role will be to *supervise*—it will not micro-manage the day-to-day management of the mutual funds. In certain circumstances, particularly when dealing with situations where conflicts of interest exist, the governance agency will make decisions.

## **5. The governance agency will carry out specific responsibilities**

To fulfil its role, a governance agency will develop a mandate that is consistent with our governance principles and identify how it wishes to carry out that mandate. We expect each governance agency to define responsibilities that are appropriate to it and the mutual funds it

oversees. Each governance agency will tell investors about its mandate. We encourage the industry to develop best practices on the responsibilities of governance agencies.

In the absence of industry best practices, we expect a governance agency to carry out the specific responsibilities we set out below, in addition to any other function the governance agency believes is important. The specific responsibilities we outline are minimum standards only; governance agencies will consider whether other more extensive duties are relevant. We expect fund managers to facilitate the execution of these duties, for example, by supplying information the governance agency requests or requires.

A governance agency will:

- a. ask senior officers of the mutual fund manager to meet regularly with it and provide it with whatever information about the specific mutual funds that the governance agency feels is necessary to carry out its role.
- b. identify the policies and procedures of the fund manager that are material to investors. If the fund manager does not have any specific written policies and procedures, the governance agency will ask that these policies and procedures be developed. At a minimum the governance agency will require that the fund manager develop policies and procedures addressing the following. The governance agency then will approve and monitor the fund manager's compliance with these policies and procedures.
  - i. internal controls
  - ii. controls to monitor external service providers and delegated functions
  - iii. compliance with applicable securities legislation and sound business practice
  - iv. expense and cost allocations between the fund manager and its mutual funds and amongst the mutual funds themselves
  - v. valuation of portfolio assets
  - vi. brokerage allocation and soft dollar transactions
  - vii. proxy voting.
- c. consider what action to take where there has been material non-compliance by the fund manager with its policies and procedures or our regulation. Governance agencies will consider whether the non-compliance has serious implications for investors and whether it should inform the regulators about the non-compliance.
- d. consider and approve the fund manager's choice of benchmarks against which fund performance will be measured and monitor fund performance against these benchmarks.
- e. monitor that the mutual funds are managed according to their stated investment objectives and strategies.
- f. establish a charter setting out its responsibilities and its operating procedures, including:
  - i. the role of any committees and sub-committees
  - ii. quorum requirements

- iii. compensation of members
  - iv. term of membership
  - v. succession planning
  - vi. orientation program for new members
  - vii. dispute resolution
  - viii. annual assessments of its performance.
- g. act as the audit committee for the mutual funds and in that capacity:
- i. review and approve the financial statements of the funds
  - ii. communicate directly with internal and external auditors of the funds
  - iii. approve any proposal to remove the auditors and/or to appoint new auditors.
- h. approve the policies of the fund manager about transactions with related parties that involve the mutual funds and determine which transactions can only be carried out with the prior approval of the governance agency.

#### **Issues for comment**

14. Are the responsibilities we describe appropriate for a governance agency? If not, please explain why. Have we neglected to mention any responsibilities that should be ascribed to the governance agency? For example, should the governance agency review or approve mutual fund disclosure documents?
15. Can you think of any other policies and procedures the governance agency should review and approve? For example, should the governance agency review policies on the use of derivatives?
16. Do you believe the independent members of the governance agency will be effective in their audit committee role?

## **6. Members of the governance agency will be subject to a standard of care**

Governance agency members will need unambiguous duties and standards of care so they may understand how to exercise their duties and meet those standards. Although applicable private law may impose a duty and standard of care, we will articulate a clear regulatory statement: governance agency members will be required to exercise the powers and discharge the duties of their office honestly, in good faith and in the best interests of investors. In so doing, they will be required to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

Both trustees of mutual funds and mutual fund managers will continue to be subject to applicable standards of care under private law (civil law in Québec and common law in the other provinces) and as set out in securities legislation in some provinces. Members of a governance agency will not necessarily be vicariously liable for the negligence or wrongdoing of a fund manager. They will only be liable for losses of investors if those losses result from their failure to discharge their duties in accordance with the standard of care. We will allow governance agency members who discharge their duties in accordance with the



standard of care and who nonetheless incur personal losses as a result of a lawsuit, to seek indemnification from the relevant mutual funds. Section 4.4 of National Instrument 81-102 provides such an avenue of recourse for fund managers in similar circumstances.

### **Standards of care for governance agency members**

The Stevens legal research paper suggests that governance agency members will likely owe a fiduciary duty to investors to act honestly and in good faith with a view to the best interests of investors. When governance agency members are performing their duties, they must exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Civil law does not have a concept of “fiduciary duty” as such, but it does have a set of rules and principles that are generally analogous to the common law doctrines governing fiduciary duties. These would, in general, likely apply to the governance agency members. In particular, members of the governance agency would be classified as administrators of the property of another. As such they would likely be obliged, like fiduciaries at common law, to act with prudence and diligence, honestly and faithfully in the best interests of their beneficiaries.

Directors of mutual fund corporations will be subject to the standard of care for directors under corporate law.

### **Issues for comment**

17. The Fund Governance Committee of The Investment Funds Institute of Canada (IFIC) recommends that we limit the liability of a governance agency member for breaches of the standard of care to \$1 million. In part because members of boards of directors of corporate mutual funds will not have this limitation on their liability we do not propose to regulate any limits on liability. Also, we are not convinced such a limitation is in the public interest. What are your views?
18. Will a regulatory statement on the standard of care for governance agency members allow potential members to assess their personal exposure in so acting? Will potential qualified members be deterred from sitting on governance agencies?
19. If you have experience with a governance agency for your mutual funds, how have you analysed their liability under common law or otherwise? Have you obtained insurance coverage for the members of your governance agency?

## **7. Appointment of the governance agency members**

The first members of the governance agency may be appointed by the mutual fund manager or elected by investors, at the option of the fund manager. Thereafter, individuals chosen by the governance agency members will fill any vacancies on the governance agency. The fund manager and the governance agency members responsible for appointments will consider the qualifications of prospective members to so act, including their status as independent members if applicable. Governance agency members should understand the nature of the time commitment required to act as a member of a governance agency and be prepared to devote sufficient time.

If a governance agency member resigns, he or she will tell the fund manager and the other members of the governance agency the reasons for the resignation.

Fund managers will send investors notices telling them about all new appointments and resignations. These notices will be sent within a reasonable time after the appointment or resignation and must be filed publicly with us on our electronic filing database, SEDAR. These notices can be combined with and delivered at the same time as other investor communications. Notices will tell investors about the qualifications and experience of new members and will explain whether or not these members are independent of the fund manager. If a member is not an independent member, the fund manager will explain why the member is not independent. If a governance agency member resigns, the notice will say why the member resigned.

The names, experience and relationships of the governance agency members will be outlined in each mutual fund's point of sale disclosure documents.

### **Investors need to be connected to their governance agency**

In essence, our proposals for improved governance of mutual funds are investor protection initiatives. A perfect governance system would allow the investors to nominate and elect the members of the governance agency. However, annual meetings, or even one-time meetings to appoint the first members, for the over 2,500 mutual funds in Canada are simply not feasible. In addition to the logistical and cost considerations of meetings, we question how a governance agency that oversees all mutual funds in a fund family (in some cases, over 100 mutual funds are in a fund family) can ever be elected by the investors in each of those mutual funds.

Two issues are raised by the initial appointment of governance agency members by fund managers:

- will it create an insurmountable bias in favour of the fund manager and
- how real will the governance agency's accountability to investors be, if investors have no part in their appointment?

We must be satisfied with the resolution of these issues.

### **Issues for comment**

20. Are there alternatives to the appointment-election conundrum we outline? Is there another practical way for members to be appointed to fund governance agencies?
21. What do you think about the issues associated with fund managers appointing governance agency members? Are these real or theoretical? If you act on a governance agency and were appointed by the fund manager, please share your experience with us.
22. Should investors who do not like the elected/appointed governance agency members be allowed to exit without penalty? Do we need to give any guidelines for qualifications of prospective members of a governance agency?

## 8. Compensation of the governance agency members

The governance agency will set their own compensation, which can be paid out of fund assets. However the fund manager will have the ability to call an investor meeting to ask that investors consider any compensation that the manager believes is unreasonable. The compensation paid to governance agency members will be disclosed in each mutual fund's point of sale disclosure documents. Investors will be given advance notice of any proposed increases in the amount of compensation to be paid—including advance notice of the compensation the first governance agency members propose.

As part of its overall cost allocation policy, the fund manager will establish procedures for fairly allocating the governance agency costs amongst the applicable mutual funds. This procedure will be approved and monitored by the governance agency.

### Issues for comment

23. Some people are concerned about the lack of checks and balances on the governance agency setting its own compensation. We do not currently propose to place any limits on the amount or kind of compensation that may be paid to governance agency members. Should we set limits to give guidance to the industry? Should the mutual fund manager be involved in the process of setting the governance agency's compensation or not? Would the independence of governance agency members be compromised if the mutual fund manager set and paid their compensation directly? What do you think about our proposal that the fund manager be given veto power via the ability to call a special meeting to have investors consider any compensation that the fund manager believes is unreasonable?

## 9. Dispute resolution

If a governance agency's disagreement with the mutual fund manager cannot be resolved using the dispute resolution procedures set out in the governance agency's charter, the governance agency will have the option to put the issue before investors at special meetings called for that purpose. If the governance agency chooses not to put the issue to an investor meeting, it must tell investors about any unresolved dispute and how it proposes to deal with it. This investor communication would be mailed to investors and filed publicly with us on our electronic filing database, SEDAR.

If the fund manager, working diligently, cannot resolve a dispute with the governance agency within a reasonable period of time, the fund manager would file an amendment to the mutual funds' prospectus documents and issue a press release describing the dispute.

The governance agency will not have the power to terminate the fund manager's appointment as manager, without authorization from the investors. However, investors of a mutual fund would have this option at a special meeting called by the governance agency for the purpose of considering whether or not to terminate the fund manager.

A fund manager may decide that the governance agency or individual members are not performing duties or carrying out responsibilities in accordance with the standard of care.

Fund managers will have the option of calling investor meetings to have them terminate the appointment of governance agency members and elect new members. Governance agency members can also decide to terminate the appointment of non-performing colleagues on the governance agency by means of an investor meeting.

### **Two controversial issues:**

#### **The power to terminate the manager**

A board of directors of a corporation has the power to remove and replace the chief executive officer of the corporation. People analogize fund governance to corporate governance and say that the governance agency will only have real powers or teeth if it can dismiss the fund manager. We think that this unilateral power in the hands of governance agencies is not practical for mutual funds. Investors invest in a specific mutual fund when they are comfortable with the fund manager. Dismissing the fund manager would not only subvert investor wishes, but would leave mutual funds virtually orphaned. Who would take over the management of the mutual fund? We believe governance agencies need to be able to initiate investor meetings—particularly where the governance agency has a significant problem with the fund manager—and be able to suggest a change in manager to investors. Giving investors the ultimate power to change the fund manager or decide a dispute is a more realistic approach.

#### **What to do about “loose cannons” on the governance agency?**

If fund governance agency members are to be appointed, but not otherwise re-nominated and re-elected by investors on an annual basis, we must consider the possibility of a governance agency or individual members of a governance agency not performing. A governance agency should assess its own performance and the contribution of individual members on an annual basis. A fund manager can equally develop performance standards, in consultation with the governance agency. When a fund manager has reasonable grounds for asserting that the governance agency or an individual member is not carrying out responsibilities properly, in the event the matter cannot be resolved, the fund manager will have the option of asking investors to replace the member(s) of the governance agency. Investors in every fund overseen by the governance agency should be asked to make that decision.

### **Issues for comment**

24. Will the governance agency have sufficient powers in the event of a dispute with a fund manager? Will it be able to discharge its functions properly? If not, can you suggest alternatives for effective dispute resolution? If you do not agree with our discussion on the powers to terminate the fund manager, please explain why you disagree.
25. What do you think about our suggested approach for dealing with non-performing fund governance agencies or individual members? Do investors or fund managers need any additional powers or information?

## **10. Reporting to investors**

Investors will receive:

- i. point of sale disclosure of:
  - (a) the name and background of each governance agency member
  - (b) the compensation paid to governance agency members
  - (c) the responsibilities of the governance agency.

- ii. annual reports from the governance agency including information on:
  - (a) the activities of the governance agency
  - (b) any changes in its membership and compensation
  - (c) its assessments of its performance
  - (d) any unresolved disputes between the governance agency and the mutual fund manager.

We will expect fund governance agencies to consider industry standards when providing other information to investors. We will encourage fund governance agencies to ensure that their standards of disclosure are at least equal to the standards followed by corporations. The annual reports of the governance agency may be combined with other investor communications, such as the annual reports of the mutual funds in a fund family.

**Issues for comment**

- 26. What information do you think investors should receive about the governance agency in addition to, or in substitution for, the information we outline?

### **1.3 How will the CSA implement governance agency requirements?**

- 1. We propose to change our regulation to require fund families to create fund governance agencies. We will use available and appropriate regulatory tools to achieve this result—rule- or regulation-making or recommending changes to provincial legislation. Some of our proposals can be implemented through policy statements that interpret our rules or legislation.
- 2. We expect to build-in ample transition periods for the implementation of any fund governance requirements. That is, we will not expect fund governance agencies to be created overnight once our regulatory changes take effect. Our regulation will allow governance agencies to develop over time.
- 3. We will encourage industry participants to develop education programs for new members of fund governance agencies. We expect the learning curve for new members, particularly in the early phase of implementation of our proposals, will be steep.

**Issues for comment**

- 27. How much time do you think we should allow mutual fund managers to develop their governance agencies?
- 28. What kind of training programs do you think will be necessary for fund governance agency members?

## II. Registration of mutual fund managers

This part of the concept proposal deals with what is really the first pillar of our proposed regulatory framework: new minimum standards for mutual fund managers established through a registration regime tailored to the business of managing mutual funds.

### 2.1 The mechanics of registration

We will require every mutual fund manager to be registered with a principal regulator, or regulators, before they may act as a mutual fund manager. We will create a new registration category for mutual fund managers, separate from the adviser and dealer categories. Mutual fund managers will not have to also register as an adviser or a dealer, if they are carrying out those functions.

Our new registration regime will outline basic conditions of registration for all mutual fund managers and will also establish additional conditions for those fund managers who act as portfolio managers and investment counsel (that is, those who are presently registered as advisers) or who trade in mutual fund securities (that is, those who are presently registered as dealers). These additional conditions of registration will be modelled on existing requirements for advisers and dealers.

#### Issues for comment

29. What are your views on registration of mutual fund managers? People have told us that they are concerned our proposals will introduce an additional bureaucratic registration system. If you share these concerns, please feel free to share them with us. However, please understand that our aim is to ensure that the mechanics of registration are as streamlined as possible. We are most interested in your views on our proposals about the conditions of registration of fund managers.

### **How does this pillar of our proposed framework fit with fund governance?**

The first two pillars of our proposed regulatory framework are connected but separate. Registration will establish the conditions that must be met before a registrant will be permitted to manage mutual funds, while fund governance will ensure that that fund manager manages mutual funds in ways that are in the best interests of investors.

Manager registration will achieve two main objectives. It will:

- give regulators oversight over companies acting as mutual fund managers; and
- ensure consistent national minimum standards for mutual fund managers in Canada—mutual fund investors will have the same protections regardless of where their fund managers are located.

Registration will enable us to regulate who comes into the industry and to screen out insolvent companies, those that do not have the required level of capital, and those that do not have adequate compliance measures. It represents a proactive approach to the regulation of mutual funds and their managers.

### **Can fund governance be a reasonable substitute for manager registration?**

A mutual fund governance regime will address the way mutual fund managers manage their funds; it will not concern itself with how a fund manager is organized, its staffing or its level of capital. Governance agencies will not be expected to pass judgement on these issues, except to the extent that they will be approving and monitoring important policies of fund managers. We expect fund governance agencies to focus on what is material to investors about the operation and management of their funds. It is unrealistic to expect governance agencies to both carry out their fund governance duties and focus on the internal operations of fund managers.

## **2.2 The conditions of registration**

To be registered as a mutual fund manager, the manager must meet conditions of registration established by us. Conditions of registration will include the following requirements.

### **1. Senior management positions**

- a. Each mutual fund manager will fill the following senior management positions:
  - i. chief executive officer
  - ii. chief financial officer
  - iii. senior administrative officer and
  - iv. senior compliance officer.
- b. The mutual fund manager's board of directors will consist of at least three persons. We will not require any independence for the members of this board.

### **2. Criminal record checks for senior officers**

Police and disciplinary checks will be conducted on senior officers and directors of the fund manager by the principal regulator. We will clearly articulate which criminal records are bars to registration.

### 3. Minimum proficiency

- a. Each of the senior officers and directors of the fund manager will have at least three years of direct experience working in, or providing service to, the investment fund/securities industry. The chief financial officer will have suitable financial and accounting training, as well as the expertise to enable such officer to fulfil the functions of such office.
- b. Senior officers will successfully complete:
  - i. the Partners', Directors' and Senior Officers' Qualifying Examination (Canadian Securities Institute) or
  - ii. the Officers', Partners' and Directors' Course (IFIC) or
  - iii. an acceptable equivalent to the above.

#### **Why do we need a minimum proficiency requirement?**

We agree with the Investment Funds Steering Group's conclusion that "management must be sufficiently knowledgeable and experienced so as to make sound day-to-day operating and investment decisions which are in the best interests of the investors" (*The Stromberg Report: An Industry Perspective*, November 1996, at 30)

#### **Issues for comment**

30. The Fund Governance Committee of IFIC recommends that the fund governance agency be responsible for considering the qualifications and proficiency of management. If the governance agency does not believe the fund manager has the right people to undertake the task of managing the funds, it should require changes. If the fund governance agency has this power, the Committee submits that we do not need to impose regulatory standards.

We do not agree with the assertion that the fund governance agency should take on this role. Our registration system for advisers and dealers sets out standards for their officers and directors and we think similar requirements should apply to fund managers. We think the governance agency should be responsible for overseeing the management of mutual funds, not for assessing the adequacy of senior management and the directors of the fund manager. Do you have any thoughts on this matter?

### 4. Filing of the fund manager's financial statements with the regulator

Mutual fund managers will file their annual audited financial statements with the principal regulator.

### 5. Minimum capital

Mutual fund managers will meet minimum capital requirements. Capital requirements will be phased in over a three-year period after implementation of this requirement.



## **The capital issue:**

### **Why do fund managers need to meet minimum capital levels?**

Commentators give the following reasons that fund managers should have minimum levels of capital:

- a. Capital will require mutual fund managers to maintain adequate financial resources to meet their business commitments, including providing quality staff, equipment, systems and services to support the assets of fund investors
- b. Capital will ensure that mutual fund managers have the ability to satisfy any major legal claims, such as accountability for prospectus disclosure, which may be made.
- c. Capital will offer some protection against the risk that the mutual fund manager will collapse and not meet its liabilities.

### **How should we calculate minimum capital requirements?**

We have not yet selected a means of calculating minimum capital amounts. The following recommendations have been made to us:

#### **Stromberg Report Recommendation**

Capital should be set at \$1,000,000 and should increase as fund assets increase according to the following scale:

- Less than - \$100 million - \$1,000,000
- \$100 million - \$200 million - 1.00% up to \$2,000,000
- \$200 million - \$1 billion - 0.25% up to \$4,000,000
- \$1 billion - \$5 billion - 0.10% up to \$8,000,000
- \$5 billion and over - 0.05% over \$8,000,000

#### **Steering Group Report Recommendation**

A formula for minimum capital requirements should consist of the following tests:

- a. A level of working capital calculated in accordance with generally accepted accounting principles; and
- b. A level of net worth calculated under generally accepted accounting principles, based on net assets under management. This would consist of a set minimum amount (for example \$1 million), plus an additional amount that varies depending on the net assets under management:
  - for net assets under management of \$100 million to \$500 million - an additional 50 basis points of such net assets
  - for that portion of net assets in excess of \$500 million to \$2 billion - an additional 35 basis points of such net assets;
  - for that portion of net assets in excess of \$2 billion to \$5 billion - an additional 25 basis points of such net assets;
  - for that portion of net assets in excess of \$5 billion - an additional 10 basis points of such net assets

#### **Stephen Erlichman's recommendation**

Review other recommendations, including the Australian Law Reform Commission's recommendation that capital should be set at 5 percent of the value of the assets of all mutual funds managed by the manager, subject to a minimum of \$100,000 and a maximum of \$5,000,000.

## **Issues for comment**

31. Do you believe a minimum capital requirement is justified? What do you think about the three options that have been recommended to us? Can you suggest an alternative option?

## 6. Minimum insurance

- a. Minimum bonding and insurance requirements will be established for mutual fund managers.
- b. The insurable risks will include:
  - i. errors and omissions
  - ii. fidelity coverage
  - iii. directors' and officers' liability
  - iv. property and casualty
  - v. business interruption
  - vi. "on premises"
  - vii. "in transit"
  - viii. forgery or alterations
  - ix. securities.
- c. The board of directors of a mutual fund manager will certify that full consideration has been given to the amount of bonding or insurance necessary to cover the insurable risks in the manager's business.

### Issues for comment

32. Is our list of insurable risks complete? We will need to determine the appropriate minimum levels of coverage for the insurable risks. Can you offer us any guidance on this matter?

## 7. Implementation of internal controls, systems and procedures

- a. Each mutual fund manager will establish appropriate internal control procedures and a system for reporting on them. Internal control procedures for the following functions will be articulated by fund managers:
  - i. transfer agency
  - ii. fund accounting
  - iii. trust accounting
  - iv. detecting and reporting any money laundering activities
  - v. disaster recovery, contingency planning and business continuity
- b. External auditors will perform periodic reviews of the adequacy of the mutual fund manager's internal control procedures. This report will be filed with the principal regulator.
- c. Managers will be required to report annually on their compliance with internal controls. This report will be filed with the principal regulator.

- d. We will encourage industry participants to develop best practices on the appropriate internal control procedures for fund managers.

### **Issues for comment**

33. Is our list of essential internal controls complete? Do you think our proposal for an auditor review of internal controls is necessary? Why or why not? Do fund managers today routinely ask their auditors to conduct this review?

## **8. Controls to monitor external service providers and delegated functions**

A fund manager will be required to have adequate resources, systems and procedures and personnel in place to monitor the services provided by third parties. For example, if third parties are retained to provide investment advisory services, the fund manager will be required to have staff with sufficient knowledge, expertise and experience in portfolio management who will be responsible for oversight and assessment of the adequacy of the services provided by third party portfolio managers.

### **Why do mutual fund managers need to monitor their service providers?**

Although there are numerous benefits to the delegation of functions by a mutual fund manager to a third-party service provider, this should not reduce the protections available to investors, or be used by the mutual fund manager as a way of avoiding the minimum standards imposed by our regulation.

The practice of outsourcing essential services for mutual funds raises a number of potential issues for the manager because:

- It is not assured of priority service
- It loses control over the adequacy of the systems and controls, the provision of the services, and the timing and accuracy of the processing
- It does not have any control over the substantial cash flow
- It does not have control over the quality of service.

It is part of the manager's responsibility to ensure that a service provider has adequate resources to properly perform advisory and distribution functions. Monitoring of services providers is also prudent in light of the fact that fund managers are legally accountable for the actions of their service providers.

### Issues for comment

34. It has been suggested to us that the CICA provisions respecting Section 5900 Reports may be of assistance in discharging regulatory obligations of the fund manager to satisfy itself, and demonstrate on an ongoing basis, that a third party service provider is competent to fulfil the functions in question. Independent external auditors would perform this audit and the report would be filed with the manager and regulators. Do you believe a Section 5900 Report would be useful in this context? Why or why not?
35. Can you think of any other minimum standard that should apply to fund managers as a condition of registration?

## III. Product regulation

This part of our concept proposal briefly outlines our plans to re-evaluate the existing regulation of conflicts of interest and the structure of mutual funds to eliminate redundancies created by the addition of improved fund governance and registration of fund managers.

### 3.1 Regulatory restrictions to be re-evaluated

- a. We will consider whether the following regulatory restrictions may be simplified:
  - i. The prohibitions and restrictions on related party transactions, including prohibitions and restrictions against:
    - (a) investing in a security for 60 days if a related dealer underwrote the offering
    - (b) dealings between “responsible” persons
    - (c) investing in mortgages if the transaction is not at arm’s length
    - (d) inter-fund trading
    - (e) principal trading and fund acquisitions of securities of a related party.
- b. We will consider whether the following regulatory restrictions may be simplified:
  - i. The investment restrictions and practices, including:
    - (a) concentration restrictions
    - (b) restrictions concerning illiquid assets
    - (c) restrictions on investments in other mutual funds or specified types of securities
- c. We will re-examine each of the Parts currently contained in National Instrument 81-102 Mutual Funds to determine whether the detailed rules can be either eliminated or replaced with more general principles or guidelines. Other applicable legislation may also be re-examined.

- d. We will require each mutual fund manager to develop policies articulating how the general principles and guidelines, referred to above, are to be applied. The governance agency or agencies for each mutual fund family will be responsible for ensuring the manager complies with its policies.

#### **Issues for comment**

36. Please provide us with your views on how we can best achieve our objectives of re-evaluating product regulation. What changes are most important to you and why are they important? What aspects of product regulation do you think cannot be changed?
37. Is it realistic to expect that the governance agency will ensure the manager complies with its policies on such matters as related-party transactions? Can this approach replace the current conflicts of interest rules?

## **IV. Investor rights**

The fourth pillar of our proposed regulatory framework for regulating mutual funds and their managers rests on the importance of disclosure and investor rights. We explained earlier in this concept proposal that we do not propose to change our disclosure regime, through our proposals outlined in this concept proposal.<sup>13</sup> This part of our concept proposal describes what investor rights we propose to change as part of our renewed framework.

#### **What rights should investors have?**

Our regulation of mutual funds gives investors the right to know about, and in certain cases, vote on changes a fund manager may wish to make to its mutual funds. We continue to think that advance notice and, in certain cases, the ability to vote are important investor rights. However, many commentators have suggested that we could rely on a fund governance agency for decision making on behalf of investors in certain circumstances. If we improve mutual fund governance in the ways we are thinking about, we agree that this change may be an option, particularly for changes in auditors of mutual funds. Segregated fund regulation does not require investor meetings to be called for changes in auditor while current mutual fund regulation does. Fund managers have told us they want this flexibility.

Consolidation in the mutual fund industry has given rise to a number of fund manager changes. While changes in manager require fund investor approval, changes in control of manager do not under the current regime. We need to consider this inconsistency as a follow-on to our proposal to register fund managers.

Segregated fund insurance regulation provides for minority rights while mutual fund regulation does not (although segregated fund holders do not have voting rights in the event of fundamental changes). We want to re-examine this issue as we move forward with our project to harmonize the regulation of mutual funds and segregated funds as members of the Joint Forum of Financial Market Regulators.

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<sup>13</sup> Provincial regulators are presently considering changes designed to modernize the continuous disclosure regime for mutual funds.

## 4.1 Investor rights

- a. We will re-examine whether investor meetings need to be called when fundamental changes, including changes in manager resulting from indirect changes in control, to mutual funds are proposed. For example, today changes in auditors of a mutual fund need to be approved by investors. We are considering whether governance agencies could be asked to make decisions on fundamental changes as a substitute for, or in addition to any necessary investor approvals. Fund governance agency members may be as qualified as fund investors to make these decisions. Having governance agencies approve fundamental changes rather than investors at special meetings will serve to reduce costs to mutual funds and fund managers and indirectly to investors.
- b. Through our work with our insurance colleagues on the Joint Forum of Financial Market Regulators, we know insurance regulators have considered what rights to give investors in segregated funds where fundamental changes to their investment are proposed. We will monitor the implementation of their changes and consider whether minority rights should be provided to mutual fund investors who do not agree with a particular fundamental change to their mutual fund. Although we canvassed this issue while finalizing National Instrument 81-102, we believe this area merits reconsideration once we examine the final provisions of corresponding insurance regulation.
- c. We also will review investor rights as we develop specific rules for governance agencies. We may need to define additional investor rights in order to achieve our objectives for fund governance.

### Issues for comment

38. What are your views on the specific areas that we are re-considering? Are there other changes we should consider in the area of investor rights in light of our proposed renewed framework? Do we need to consider defining additional rights for investors?

## C. The benefits of our renewed framework versus its costs

Our proposed renewed framework for regulating mutual funds represents a significant shift in our approach to mutual funds. We know that all regulatory actions have their costs, however it is important to us that the benefits of our proposed changes outweigh the potential costs. We owe a commitment to the industry and consumers to proceed with regulatory reform only where the benefits clearly outstrip the costs.

While developing this concept proposal, we were careful to consider the potential business and regulatory costs of our proposals. In order to gain a better understanding of the costs associated with our proposals, we surveyed fund managers about the costs of their various governance agencies. The OSC's chief economist also conducted independent research.

The OSC's chief economist has estimated, on a preliminary basis, the costs of creating and operating a governance agency of the nature we propose. He estimates that, at most, these costs will represent no more than 0.016 percent of total industry assets under management. Our preliminary view is that our proposals for improved fund governance should not place an undue burden on mutual fund managers or mutual funds.

We believe the costs of our proposals will be more than offset by the benefits. These will include important qualitative benefits that are hard, if not impossible, to assign a dollar figure to—such as those we describe in Part A of this concept proposal. The staff research paper contains a detailed analysis of the potential costs of our proposals as well as a proposed framework for quantifying certain of their direct benefits.

### **We have an obligation to analyse the costs versus the benefits For example, section 2.1 of the *Securities Act* (Ontario):**

“Business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized”.

### **Issues for comment**

39. Upon reading the staff research paper, what are your views on the costs of our proposals versus the benefits? Should we take into account other costs? Other benefits?

## D. What happens next?

### 1. We will accept comments on our proposals until June 7, 2002

As we explained earlier, we will accept your comments until June 7. If you have any questions about our proposals, you may contact the following staff members for clarification:

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## **2. We will review the comments on this concept proposal**

We will carefully read your comments as we receive them. Once we have analysed your comments and completed any additional consultation we think is necessary, we will proceed to draft changes to our regulation.

## **3. We will publish for comment the specific changes to our regulation**

We expect to release for comment draft rules or regulations and policy statements setting out our proposals for improved fund governance and registration of fund managers. We will also provide more detail on our proposals to change product regulation and investor rights.