CSA/ACVM
Canadian Securities Administrators
Autorités canadiennes en valeurs mobilières

Notice of National Instrument 81-107

Independent Review Committee for Investment Funds

CSA Notice of Rule, Commentary and Related Amendments

Introduction

We, the members of the Canadian Securities Administrators (the CSA or we), have developed an independent oversight regime for all publicly offered investment funds[1] that is intended to improve investment fund governance. This regime is set out in National Instrument 81-107 *Independent Review Committee for Investment Funds* (the Rule).

Investment Fund Governance in Canada

The Canadian investment fund industry is a key segment of the financial services marketplace. With over $630 billion in assets under management, a sizable amount of public money and, by extension, public trust, is invested in the fund industry. Investors expect high standards of conduct from the stewards of their money. Yet, the conflicts of interest faced by fund managers may present a real challenge to their ability to meet their fiduciary duty to their funds and investors. There is currently no one whose sole responsibility it is to look out for the interests of investors. This has led us to consider the need to improve the governance of investment funds.

The International Organization of Securities Commissions (IOSCO)[2] recently defined investment fund governance to be a framework for the organization and operation of investment funds that seeks to ensure that investment funds are organized and operated in the interests of fund investors, and not in the interests of fund insiders.

For over 30 years, much of the literature written on investment funds and fund governance[3] has concluded that the structure of the fund industry – where the investor's

---

[1] This includes mutual funds, commodity pools, scholarship plans, labour-sponsored or venture capital funds, and closed-end funds and mutual funds that are listed and posted for trading on a stock exchange or quoted on an over-the-counter market.
[2] *Examination of Governance for Collective Investment Schemes – Consultation Report* prepared by the Technical Committee of IOSCO, February 2005.
[3] See, for example, the *Report of the Canadian Committee on Mutual Funds and Investment Contracts – Provincial and Federal Study*, 1969, Queen's Printer, 1969 prepared by Jim Baillie*; Regulatory Strategies for the Mid-90s: Recommendations for Regulating Investment Funds in Canada,* prepared by Glorianne Stromberg for the CSA, January 1995; *Making it Mutual: Aligning the Interests of Investors and Managers: Recommendations for a Mutual Fund Governance Regime in Canada,* prepared by Stephen

"ownership" of the fund is separate from the fund manager's management and control of the fund – creates the potential for the interests of fund investors to diverge from the pecuniary interests of the fund manager. This could cause a fund manager to act contrary to its fiduciary duty to the investment fund (and ultimately, investors).

In Canada the potential for the interests of investors to diverge from the interests of the fund manager is exacerbated by the fact that often related parties carry out all of the requisite services provided to the investment fund, without any review of the terms or the manner in which these obligations are being carried out by unrelated persons. Coupled with this is the fact that investors are far removed from the fund manager and the decisions made by the manager or its agents. Investors rarely have the resources, the tools, or the inclination to effectively oversee the fund manager of their investment fund.

The Canadian regulatory regime for conflicts of interest currently relies on the fiduciary obligations of the fund manager set out in certain provincial securities legislation, and the prohibition of certain relationships or transactions. Although regulators have broad discretion to grant relief from those prohibitions, this discretion is generally exercised in narrow circumstances, and it has proven difficult for regulators to always provide timely relief. We recognize that our prohibition-based approach is too restrictive on the one hand, because it prohibits transactions that we acknowledge may be innocuous or even beneficial to investors, and not inclusive enough on the other, because it only deals with certain specific related-party transactions.

The Rule imposes a minimum, consistent standard of independent oversight for all publicly offered investment funds in each of the jurisdictions represented by the CSA.

We believe the Rule strikes the right balance between protecting investors and fostering fair and efficient capital markets. We also believe the Rule keeps pace with global standards, which we consider essential to the continued success of the Canadian investment fund industry. The CSA expect that fund governance will evolve with time, and we anticipate that the governance framework set out in the Rule will provide a flexible platform for future regulatory reform. We are committed to reviewing the impact of the Rule following its implementation.

Consequential Amendments and Adoption of the Rule

We are also publishing a companion policy to the Rule, which we call Commentary. We refer to the Rule and Commentary, together, as the Instrument.

Erlichman for the CSA, June, 2000; *Conflicts of Interest of CIS Operators* prepared by the Technical Committee of IOSCO, May 2000; *Examination of Governance for Collective Investment Schemes – Consultation Report* prepared by the Technical Committee of IOSCO, February 2005.

Concurrently with the Instrument, we are publishing related consequential amendments to the following Instruments:

- National Instrument 81-101 *Mutual Fund Prospectus Disclosure*, Form 81-101F1 *Contents of Simplified Prospectus,* and Form 81-101F2 *Contents of Annual Information Form*;
- National Instrument 81-102 *Mutual Funds* (NI 81-102) and Companion Policy 81-102CP *Mutual Funds*;
- National Instrument 81-106 *Investment Fund Continuous Disclosure* and Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance*;
- National Instrument 13-101 *System for Electronic Document Analysis and Retrieval (SEDAR)*;
- National Instrument 81-104 *Commodity Pools*; and
- in some jurisdictions, certain local amendments.

The Rule has been adopted or is expected to be adopted as a rule in each of British Columbia, Alberta, Manitoba, Newfoundland and Labrador, Nova Scotia, Ontario and New Brunswick, as a commission regulation in Saskatchewan, as a regulation in Québec, and as a policy in the remaining jurisdictions represented by the CSA. The Commentary contained in the Rule will be adopted as a policy in each of the jurisdictions represented by the CSA.

In Ontario, the Instrument, consequential amendments and other required materials were delivered to the Minister of Government Services on July 28, 2006. The Minister may approve or reject the Instrument or return it for further consideration. If the Minister approves the Instrument or does not take any further action, the Instrument and consequential amendments will come into force on November 1, 2006.

In Québec, the Instrument is a regulation made under section 331.1 of *The Securities Act* (Québec) and must be approved, with or without amendment, by the Minister of Finance. The Instrument will come into force on the date of its publication in the *Gazette officielle du* Québec or on any later date specified in the regulation. It is also published in the Bulletin of the Autorité des marchés financiers.

In British Columbia, the implementation of the Instrument and consequential amendments are subject to ministerial approval. British Columbia also plans to adopt a local instrument that exempts from the Instrument and consequential amendments an investment fund that is a reporting issuer only in British Columbia. You can read more

about this exemption in the notice that British Columbia has published about the Instrument.

Provided all necessary approvals are obtained, we expect the Rule and consequential amendments to come into force on November 1, 2006.

Compliance with the Rule may take place over a one year transition period. The Rule also specifies that existing conflict of interest waivers and exemptions that deal with any matter that the Instrument regulates may not be relied on after one year following the coming into force of the Instrument.

Summary and Purpose

Purpose of the Rule

Currently, there is no requirement for investment fund managers or investment funds to have any type of independent oversight of how they manage or monitor conflicts of interest. In compliance with the governance principles recently articulated by IOSCO[4], the Rule provides for the independent review and oversight of the conflicts faced by the fund manager in the operation of the investment fund.

We expect the Rule to enhance investor protection by ensuring that the interests of the investment fund (and ultimately, investors) are at the forefront when a fund manager is faced with a conflict of interest. The Rule will also improve the transparency surrounding a fund manager's fiduciary obligation and decision-making process in such situations, by requiring an upfront check on how the conflict of interest is resolved. This process does not mean, nor do we intend it to result in, the second-guessing of the investment or business decisions of the fund manager. However, it does mean that, for the first time, the fund manager must formally account for each decision involving a conflict of interest to an independent body considering the decision solely from the perspective of the best interests of the investment fund and its investors.

We also expect the Rule to contribute to more efficient Canadian capital markets by permitting fund managers to engage in certain related-party and self-dealing transactions without prior regulatory approval[5]. This will give fund managers greater flexibility to make timely investment decisions to take advantage of market opportunities they believe are in the best interests of the investment fund and investors.

---

[4] *Examination of Governance for Collective Investment Schemes – Consultation Report* prepared by the Technical Committee of IOSCO, February 2005.

[5] These transaction are inter-fund trades, purchases by a mutual fund of the securities of related issuers and purchases of securities by mutual funds during the distribution period and the 60 day period thereafter where the offering is being underwritten by a related party.

The CSA believe managers of all investment funds, large and small, face conflicts of interest and will benefit from the independent perspective brought to bear by an independent body on such matters. We believe the costs associated with the Rule, published with the 2004 Proposal and the 2005 Proposal, will be proportionate to the benefit. We are further satisfied that the limited scope of the independent body's mandate will in turn limit its corresponding fiduciary duty and duty of care.

Summary of the Rule

The Rule requires every investment fund that is a reporting issuer to have a fully independent body, the Independent Review Committee (IRC), whose role is to oversee all decisions involving an actual or perceived conflict of interest faced by the fund manager in the operation of the fund.

The Rule captures two types of conflicts: (i) 'business' or 'operational' conflicts - those relating to the operation by the manager of its funds that are not specifically regulated under securities legislation, except through the general duties of loyalty and care imposed on the fund manager; and (ii) 'structural' conflicts – those conflicts resulting from proposed transactions by the manager with related entities of the manager, fund or portfolio manager currently prohibited or restricted by securities legislation.

The Rule requires that prior to making a decision involving a conflict of interest matter, the fund manager must establish written policies and procedures that it must follow and refer the matter to the IRC for its review.

A decision by the fund manager to engage in certain transactions giving rise to 'structural' conflicts currently prohibited or restricted by securities legislation, must be approved by the IRC before the transaction may proceed. The approval may be on a case-by-case basis, or in the form of a standing instruction. For any other proposed course of action that involves a conflict of interest for the fund manager, the IRC must provide the fund manager with a recommendation, which the fund manager must consider before proceeding.

The Rule also requires the IRC to approve certain changes to a mutual fund before the manager may proceed with the change. In the consequential amendments to NI 81-102 which accompany the Instrument, we specify that the IRC must approve a change in the auditor of the mutual fund, and a reorganization or transfer of assets of the mutual fund to a mutual fund managed by the same fund manager or an affiliate. We have eliminated the requirement for securityholder approval in these instances but continue to require a securityholder vote in other circumstances.

Background

In 1999, the CSA retained Stephen Erlichman to provide a summary of the discussion on governance 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 in Canada* in June, 2000[6].

On March 1, 2002, the CSA released Concept Proposal 81-402 *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers* (the Concept Proposal) setting out our vision for a renewed framework for regulating mutual funds and their managers that rested on five pillars: registration of mutual fund managers, mutual fund governance, product regulation, disclosure and investor rights and regulatory presence. The Concept Proposal proposed a very robust system of fund governance, with a 'board'-like body that would oversee all of the fund manager's activities.

On January 9, 2004, we published for comment the first version of the Rule and Commentary (the 2004 Proposal). In response to strong industry feedback to limit the role of the governance body, the 2004 Proposal narrowed the focus of the governance body (now called the IRC) to oversight of the potential conflicts of interest that exist for fund managers in the operation of their funds. The focus on conflicts of interest was deliberate. In our view, this was an area where independent review mattered most, and would not impose an undue burden on mutual fund managers who have no experience working with an independent advisory body.

For additional background information on the Concept Proposal and the 2004 Proposal, please refer to the notices published with those documents on the websites of members of the Canadian Securities Administrators.

As a result of the comments we received from stakeholders (in particular investors and investor advocates who urged us to give the IRC more "teeth"), as well as our own experience to date with the exemptive relief that we have granted from the conflict prohibitions and restrictions in securities legislation, the CSA made a number of significant changes to the 2004 Proposal to provide for a greater level of investor protection. On May 27, 2005, we published the Rule and Commentary for comment a second time (the 2005 Proposal). The comment period expired on August 25, 2005.

The 2005 Proposal introduced a number of key changes. Among them: the scope of the Rule was expanded to include all publicly offered investment funds; instead of repealing the existing conflict prohibitions and restrictions in securities legislation, the Rule codified exemptions for certain transactions giving rise to 'structural' conflicts currently prohibited or restricted by securities legislation; the Rule introduced a number of tools for

---

[6] *Making it Mutual: Aligning the Interests of Investors and Managers: Recommendations for a Mutual Fund Governance Regime in Canada,* prepared by Stephen Erlichman for the CSA, June, 2000.

the IRC to use if it determines the fund manager has placed its interests ahead of the interests of the fund in conflict of interest matters; and the Rule specified the key governance practices we expected of the IRC and the fund manager.

In response to concerns previously raised about the potential unlimited liability of IRC members, we sought advice from external legal counsel. Based on this advice, we revised the Rule to clarify the very specific functions, duties and obligations of the IRC which, we were advised, should correspondingly limit the IRC's fiduciary duty and duty of care. We published this analysis with the 2005 Proposal on the website of the Ontario Securities Commission and the website of the Autorité des marchés financiers.

The Rule continues to reflect the key changes made in the 2005 Proposal.

Throughout this initiative, we heard divergent views from stakeholders on almost every aspect of our proposals. We believe the Rule strikes the right balance between these competing points of view.

While we remain confident that the five-pillared framework for mutual fund regulation we outlined in the Concept Proposal is a sound blueprint for change, we also understand that we cannot bring all five pillars into place overnight. The CSA remain committed to the pillars of fund regulation, some of which are already in place while others are being addressed in separate policy initiatives currently underway.

Summary of Changes to the Instrument

After considering all of the comments received, we have revised the Instrument. However, as these changes are not material, we are not republishing the Instrument for a further comment period. Many of the changes we have made respond to stakeholder comments on practical matters related to the implementation and ongoing operation of the IRC.

See Appendix A for a description of the noteworthy changes we have made to the 2005 Proposal.

The independent legal analysis we published with the 2005 Proposal concerning the liability of IRC members has also been updated to reflect the drafting changes made to the Instrument. It is available on the website of the Ontario Securities Commission and the website of the Autorité des marchés financiers.

Summary of Written Comments Received on the 2005 Proposal

We received 36 submissions on the 2005 Proposal. We have considered all comments received and wish to thank all those who took the time to comment. Copies of the comment letters have been posted on the Ontario Securities Commission website at

www.osc.gov.on.ca. Copies are also available from any CSA member. The names of the commenters can be found in Appendix B to this Notice.

A summary of the comments we received on the 2005 Proposal, together with our responses, is also in Appendix B to this Notice.

Related Amendments

National Amendments

Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure* (NI 81-101), Form 81-101F1 *Contents of Simplified Prospectus,* and Form 81-101F2 *Contents of Annual Information Form* are set out in Appendix C;

Amendments to National Instrument 81-102 *Mutual Funds* (NI 81-102) and Companion Policy 81-102CP *Mutual Funds* are set out in Appendix D;

Amendments to National Instrument 81-106 *Investment Fund Continuous Disclosure* (NI 81-106) and Form 81-106F1 *Contents of Annual and Interim Management Report of Fund Performance* are set out in Appendix E;

Amendments to National Instrument 13-101 *System for Electronic Document Analysis and Retrieval (SEDAR)* (NI 13-101) are set out in Appendix F; and

Amendments to National Instrument 81-104 *Commodity Pools* (NI 81-104) are set out in Appendix G.

Local Amendments

We have amended elements of local securities legislation, in conjunction with the implementation of the Instrument. The provincial and territorial securities regulatory authorities may publish these proposed local changes separately in their jurisdictions.

Consequential amendments to rules or regulations in a particular jurisdiction, if applicable, are in Appendix H to this Notice published in that particular jurisdiction.

Some jurisdictions will need to implement the Instrument using a local implementing rule. Jurisdictions that must do so will separately publish the implementing rule.

Questions

Please refer your questions to any of:

Rhonda Goldberg
Assistant Manager, Investment Funds
Ontario Securities Commission
Tel: (416) 593-3682
rgoldberg@osc.gov.on.ca

Susan Silma
Director, Investment Funds
Ontario Securities Commission
Tel: (416) 593-2302
ssilma@osc.gov.on.ca

Susan Thomas
Legal Counsel, Investment Funds
Ontario Securities Commission
Tel: (416) 593-8076
sthomas@osc.gov.on.ca

Doug Welsh
Legal Counsel, Investment Funds
Ontario Securities Commission
Tel: (416) 593-8068
dwelsh@osc.gov.on.ca

Noreen Bent
Manager and Senior Legal Counsel, Corporate Finance
British Columbia Securities Commission
Tel: (604) 899-6741
nbent@bcsc.bc.ca

Christopher Birchall
Senior Securities Analyst, Corporate Finance
British Columbia Securities Commission
Tel: (604) 899-6722
cbirchall@bcsc.bc.ca

Bob Bouchard
Director, Corporate Finance and Chief Administrative Officer
Manitoba Securities Commission
Tel: (204) 945-2555
bbouchard@gov.mb.ca

Cynthia Martens
Legal Counsel
Alberta Securities Commission
Tel: (403) 297-4417
cynthia.martens@seccom.ab.ca

Pierre Martin
Senior Legal Counsel, Direction des marchés des capitaux
Autorité des marchés financiers
Tel: (514) 395-0558, ext. 4375
pierre.martin@lautorite.qc.ca

Julie Hamel
Analyst, Direction des marchés des capitaux
Autorité des marchés financiers
Tel: (514) 395-0558, poste 4476
julie.hamel@lautorite.qc.ca