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

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What is this background report about?

Before introducing any regulatory reforms that will change the way an industry does business, the Canadian Securities Administrators (the CSA) need to fully understand both that business and the views of industry participants on the reforms proposed. The CSA have remained aware of this need as they have worked toward the release of a concept proposal describing a renewed framework for regulating mutual funds and their managers. As David Brown explained in the forward to Stephen Erlichman's report: [1]

> Exploring the full range of perspectives and canvassing options for improving fund governance and the management of mutual funds is a Commission priority for the upcoming year…. You can expect to hear from us as we move forward.

Indeed, the Canadian mutual fund industry, its advisers, and other interested parties did hear from us. As the principal regulator of the majority of Canadian mutual funds and their managers, we, the staff of the Ontario Securities Commission (the OSC), undertook to consult widely with industry participants and gather empirical data about the mutual fund industry in Canada. Our findings, which are summarized in this report, lay the groundwork for the CSA's thinking on how best to improve mutual fund governance and the regulation of mutual fund managers.

The first part of the report describes the research we conducted: it explains the methods used and identifies the types of information captured. The next part provides a snapshot of the mutual fund industry in Canada. This snapshot conveys information about the size and shape of the industry and the players within it. The third part outlines what we have learned about the mutual fund industry's experience with, and its attitudes toward, mutual fund regulation and particularly our proposed governance principles. Finally, the report ends with a proposed framework for a cost-benefit analysis of our proposals based on what we have gathered about current industry practices and costs.

This background report is published together with the CSA concept proposal entitled, *Striking a New Balance: A Framework for Regulating Mutual Funds and Their Managers* (the concept proposal). It should be read in conjunction with that paper.

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[1] *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 (Toronto: June 2000) [hereinafter the Erlichman Report]. "Towards Improved Fund Governance: The Way Forward", Forward to the Erlichman Report (July 27, 2000).

Description of the research

Review of AIF fund governance disclosure

We began our research by looking at what mutual funds have to say about their governance practices. Our review of publicly available prospectus disclosure offered us a broad overview of the current governance practices in Canada and the information gathered became the point of departure for the other pieces of research we conducted.

Methodology

Before February 1, 2000, information about a mutual fund's governance structures was not generally available to the public. Once National Instrument 81-101 Mutual Fund Prospectus Disclosure and its forms came into force, however, this information became widely available as prospectus disclosure.[2] Item 12 of the AIF Form requires mutual funds to provide the following fund governance disclosure:

> Item 12: Fund Governance
>
> Provide detailed information concerning the governance of the mutual fund, including information concerning
>
> (a) the body or group that has responsibility for fund governance, the extent to which its members are independent of the manager of the mutual fund and the names and municipalities of residence of each member of that body or group; and
>
> (b) descriptions of the policies, practices or guidelines of the mutual fund or the manager relating to business practices, sales practices, risk management controls and internal conflicts of interest, and if the mutual fund or the manager have no such policies, practices or guidelines, a statement to that effect.

We culled this mandated disclosure from the prospectus filings that came through our office. This information was then put into a database and sorted.

Information captured

The database contains fund governance information for over 70 mutual fund managers—a number that corresponds closely to The Investment Funds Institute of Canada's (IFIC) statistics on its mutual fund manager members.[3] Although we are satisfied our information is fairly complete, we note that the data may be both over- and under-inclusive in places. The data may be over-inclusive because there has been much

[2] National Instrument 81-101 Mutual Fund Prospectus Disclosure (1999) 22 OSCB (Supp.2) [referred to as NI 81-101]. Form 81-101F1 and Form 81-101F2 [referred to as the SP and AIF Form, respectively].

[3] IFIC is the Canadian trade association for investment funds. The IFIC member's directory may be found at www.ific.ca.

consolidation in the mutual fund industry in recent times; our database includes information for managers that have taken part in mergers or that are now no longer managing mutual funds. At the same time, our data may be under-inclusive because our review only captured those managers currently offering conventional mutual funds to the public in Ontario; those mutual funds falling outside the ambit of NI 81-101 (particularly labour-sponsored investment funds and commodity pools) and those funds not sold in Ontario are not represented in the database.

Our review yielded important information on the different fund governance structures that have grown-up in the absence of a mandated fund governance regime. This piece of research gives us a sense of which governance models have been embraced by the industry and which have not. It also gives us some insight into what mutual fund managers *think* is important to investors when it comes to the governance of their funds.

In-person interviews with mutual fund managers

Although the in-person interviews with mutual fund managers were, by far, the most time consuming and labour intensive part of our research, these meetings were invaluable to us. The insights we gained through these meetings had a significant impact on our thinking about the industry and helped shape the CSA's proposals.

Methodology

While meetings with all of the mutual fund managers in Canada were not possible, or necessary, we wanted a large enough sample to give us an accurate picture of the industry. Based on our review of each manager's fund governance disclosure, we chose 30 mutual fund managers of all sizes from across the country. Some had no governance structures, while others employ the different fund governance structures currently in use. In addition to completing over 20 meetings in and around the Toronto area, we completed 5 meetings in Montreal, 2 meetings in Winnipeg and 2 meetings in Vancouver. We are satisfied that the managers we spoke to represent a broad cross-section of the industry.

We decided that face-to-face meetings with the senior management of mutual fund managers would be the best way to access the information we desired. We assumed people would be most candid in small, in-person meetings. We also assumed people would be more comfortable having us visit them in familiar quarters than being called before the regulator. As we booked the meetings, we made an effort to get beyond the legal advisers who usually speak to us on behalf of mutual fund managers—seeking, instead, to gain access to the founding business people and the key decision-makers in the industry.

Each mutual fund manager was provided with discussion topics in advance of the meetings. After we provided the attendees with a short presentation on the nature and scope of our project, we explored these topics with them in two-hour long sessions.

Information captured

During the meetings, we obtained detailed information about the internal affairs of each mutual fund manager. In addition to learning about each company's size, ownership and organization, we also learned about each one's approach to sales and distribution, portfolio management, trust arrangements, and fund governance.

We also canvassed each mutual fund manager's attitudes towards fund governance and registration of fund managers and gathered specific feedback on our proposals. During these discussions, we asked each manager to bring their business reality to bear on our proposals and invited them to highlight any issues that might be specific to their business.

In-person interviews with industry representatives, advisers to the industry, and other interested persons

In our effort to explore the full range of perspectives, we also met with the following people:

- The members of IFIC's Fund Governance Committee
- International mutual fund regulators
- Individuals who sit on mutual fund advisory boards or boards of governors
- Legal advisers to the mutual fund industry
- Auditors for the mutual fund industry
- OSC Commissioners
- Academics and critics

Methodology and information captured

We held regular meetings with the members of IFIC's Fund Governance Committee to give them updates on our work and to receive submissions on discrete issues. We often used these meetings to engage in broad discussion and debates.

We had discussions with international mutual fund regulators on specific issues around mutual fund governance. This avenue of inquiry lent a broader context to our thinking about mutual fund governance in this country. We were also able to draw on the experience of regulators with prior experience in this area.

Each of the other interviews we held tended to open with a short presentation on the nature and scope of our project. In some cases we moved on to pose direct questions, while in other cases we turned to a more free-ranging discussion. We gathered a wealth of practical information and explored different theoretical perspectives during these meetings.

Survey of mutual fund managers with governance structures

Having already completed a substantial amount of qualitative research, we felt it was important to gather some quantitative data on the mutual fund industry. Our electronic

survey was designed, with the assistance of the chief economist at the OSC, to provide us with detailed information and statistics on current governance practices and costs.

Methodology

Our first step was to identify the recipients of our survey. We were specifically interested in gathering information on each mutual fund manager in Canada with what we refer to as a governance agency—a group of individuals, or sometimes a corporate entity, that is responsible for overseeing the manager's activities vis-à-vis its funds. The mutual fund managers we included in our survey had each established one or more of the following types of governance agency:

- an advisory board
- a board of governors
- a board of individual trustees
- a registered trust company that is active in the governance of its mutual funds
- a board of directors for its corporate mutual funds.

We did not include in our survey those mutual fund managers who assign responsibility for fund governance to their own boards of directors. As we describe below, we did not restrict ourselves to mutual fund managers that have governance agencies with a majority of independent members. We were able to identify 28 mutual fund managers with governance agencies.

Our next step was to create our survey using the EZSurvey software. We designed the electronic survey so the recipients could easily click on the answer that applies to them, provide "yes" and "no" answers, and indicate dollar amounts. Although we did leave some room for any additional comments, we did not expect lengthy explanations or answers.

Information captured

The survey was designed to give us an understanding of each governance agency's structure and costs. In particular, we wished to better understand the potential costs of our proposals and the extent to which our proposals will require mutual fund managers to change their business practices.

We were pleased to obtain a 100 percent response rate. The data we received will inform the cost-benefit analysis to be completed by the chief economist at the OSC.

Survey of academic writing

We reviewed several academic sources to find published studies on the efficacy of mutual fund governance. While the majority of these studies come from the U.S. and were not written for the Canadian context, we refer to these studies in this report where relevant.

Snapshot of the industry

The panoramic view

When we step back to take in the panoramic view of the industry, it becomes obvious that the mutual fund business in Canada has grown to sizeable proportions. Our most up-to-date sources tell us that some 52 million account-holders hold over $427 billion in mutual fund securities.[4] We understand that approximately 75 mutual fund managers currently offer over 2,500 mutual funds.

A close-up on mutual fund managers

Assets under management and number of funds

Mutual fund managers in Canada run the gamut from very large to extremely small. Of the 65 mutual fund managers for which we have up-to-date statistics:

- 13 mutual fund managers have in excess of $10 billion in assets under administration.
- 17 managers have between $1 billion and $10 billion in assets under administration.
- 17 managers have between $100 million and $1 billion in assets under administration.
- 18 managers have less than $100 million in assets under administration.

The largest mutual fund manager in Canada has over $40 billion in assets under administration, while another large mutual fund manager offers a line-up of 150 mutual funds. In contrast, many small mutual fund managers have less than $100 million in assets under administration and manage less than 10 mutual funds. Needless to say, there are vast differences in size between the largest and smallest players in this market.

The differences in size are interesting when understood across provincial lines. Manitoba's two very large fund managers represent almost the entirety of their fund industry, while Quebec has no large fund managers, notwithstanding the fact that it is second only to Ontario in the number of mutual fund managers located there.[5] Quebec's very largest managers are on the smaller side of the mid-range. Alberta and New Brunswick each have one small fund manager based in their province, while British Columbia has several.[6] No fund managers are based in the other provinces.

Nature of ownership

Mutual fund managers in Canada are held in different ways by different owners. The common categories of ownership we noted were:[7]

[4] These statistics are taken from the IFIC website at www.ific.ca. and are as of January 31, 2002.

[5] A labour sponsored investment fund and a commodity pool manager are also based in Manitoba.

[6] A labour sponsored investment fund is also based in New Brunswick.

[7] It should be understood that these categories are not mutually exclusive.

- Widely held—shares of the management company (or a holding company) are publicly held and traded
- Closely held—shares of the management company are privately held
- Closely held by entrepreneur—ownership is dominated by the founding entrepreneur
- Bank owned
- Owned by life insurance company
- Owned by credit union or caisse populaire
- Owned by professional association
- Owned by U.S. or international parent

The mutual funds offered by professional associations and credit unions are what we refer to as owner-operated mutual funds. These can be distinguished from traditional mutual funds insofar as the owners of the mutual fund manager are the investors in the funds. In the professional association case, the mutual fund manager is owned by a professional association and the directors on the board of the manager include representatives of the association. The funds are sold exclusively to members of the professional association. We have come across approximately 13 such fund families during the course of our research. A number of these groups are based in Quebec. In the credit union situation, the credit union is owned by its members and the mutual funds are primarily sold to members through credit union branches. With both of these ownership models, the conflicts of interests that arise between the shareholders of the manager and fund investors do not exist because they are one and the same.

A close-up on mutual funds

Trust arrangements

Stephen Erlichman observes that most mutual funds in Canada are trusts, while only a small percentage of them are corporations.[8] The preference for this legal structure is largely dictated by tax considerations. The research confirms our understanding that the vast majority of managers choose to structure their mutual funds as trusts, rather than corporations.

There are four basic types of trustee for mutual fund trusts: (1) the mutual fund manager who also acts as trustee of the funds; (2) the unrelated registered trust company; (3) the registered trust company that is related to the manager; and (4) the individual.

In the most common scenario, the mutual fund manager is also the trustee of its mutual funds. We note that most, if not all, managers do not discharge their obligations as trustee separately from their obligations as manager of the funds. For example, one manager we spoke to does not distinguish between its roles as trustee and manager, seeing both as fiduciaries. Implicit in this is the assumption that the manager's standard of care under securities legislation to act in the best interests of the mutual fund is not

[8] *Supra* note 1 at 19.

different in kind from the fiduciary obligation owed by the trustee to the unitholders at common law.

The second most prevalent arrangement sees a unrelated registered trust company, such as Royal Trust, Trust General or Fiducie Desjardins, acting as trustee of the funds. In this case, the trust company is generally the custodian of the funds as well. These corporate trustees tend to act primarily as custodian and generally delegate most trustee functions to the fund managers. It should be noted that this kind of trust arrangement is prevalent among the mutual fund managers based in provinces with legislation that does not permit companies, other than registered trust companies, to be trustees.[9]

The next most prevalent arrangement sees a related registered trust company acting as trustee of the funds. In most cases, this kind of arrangement involves a bank- or credit union-owned mutual fund manager coupled with a trust company owned by the financial complex. Again, these corporate trustees tend to also act as custodian of the funds. However, some of these trustees differ from the trustees in the above category insofar as they are more active in discharging their duties as trustee. According to two of the mutual fund managers we spoke with, the trustees of their funds are very much responsible for the governance of their funds.[10] Other managers, in contrast, report that the trustees of their funds delegate most of their trustee functions to the managers.

The least common type of trustee used by the mutual fund managers we spoke with was the individual trustee. Only a handful of the mutual fund managers in Canada have a group of individuals acting as the trustees for their funds. The individual trustees for one group of funds we saw are taken from the senior management team of the parent life insurance company. There are no independent members in this group. We were told that these individual trustees are active in the governance of the funds.[11]

It is interesting to note that at least two of the managers we met with started with a group of individual trustees but then switched to the manager-as-trustee model. One mutual fund manager turned its group of individual trustees into a board of governors when it took over the job of trustee itself. This change was prompted in part by the desire to limit the liability of the individuals acting as trustees to the kind of liability that attaches to a corporate director. It was also prompted by the fear that the plenary powers to hire and fire the manager, included in the declaration of trust, could lead to the individual trustees taking the business away from the manager. The trustees of another manager's funds were replaced because the individuals had "too much liability" and looked at the funds in "too much detail," in the opinion of the manager.

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[9] Presently only Manitoba. This was also the case in Quebec and British Columbia until recently when legislative amendments were passed in each province to permit mutual fund managers to act as the trustee for the funds they manage.

[10] We considered these active corporate trustees to be governance agencies for the purposes of our survey.

[11] We considered these boards of individual trustees to be governance agencies for the purposes of our survey.

Arrangements for corporate mutual funds

Some of the larger mutual fund managers offer shares of mutual fund corporations, alongside the units of their mutual fund trusts, to round out their product line-up. Some of these corporate mutual funds have multiple classes of shares and are used to offer a tax advantage to non-registered investors.

Corporate mutual funds must abide by the requirements imposed by corporate statutes. However, it is incorrect to assume that all mutual fund corporations are created alike. During our research we noted that a number of mutual fund managers hold all the common voting shares of their corporate (generally multiple class) mutual funds. As a result, these managers do not conduct annual shareholder meetings for their corporate funds nor do the shareholders of those funds elect the directors—the mutual fund manager does as holder of the common shares. We are told this structure is designed to make the operation of corporate funds as much like mutual fund trusts as possible.

Mutual fund governance arrangements

While it is evident that the responsibility for the governance of mutual fund corporations lies with their boards of directors, the locus of responsibility is less obvious in the context of mutual fund trusts. The 70 mutual fund managers in our database disclose that they settle responsibility for the governance of their funds with the following entities:

- the mutual fund manager (25)
- the named president of the mutual fund manager (4)
- the trustee (19)
- both the fund manager and the trustee (19)
- a board of governors (2)
- an investment committee (1)

There appears to be some confusion in the industry as to the basic allocation of responsibility for fund governance.

More than a third of the mutual fund industry in Canada already has governance agencies in place to oversee mutual fund trusts, in the absence of a mandated fund governance regime. The governance agency models currently in-use are:

- The advisory board model. Members of this board are appointees of the trustee or manager. This board may be called an advisory committee/council or a board of governors. They may or may not be independent of the fund manager and trustee. The roles of these boards vary widely. This is the most commonly used model.

- The individual trustee model. Mutual funds in Canada have between one and six trustees who may or may not be independent of the manager. Only a handful of mutual fund managers use this model.

- The active corporate trustee model. While a number of mutual fund managers in Canada have a registered trust company as the trustee of their mutual funds, only two

have trustees that are sufficiently active in the governance of their funds to be considered governance agencies.

The remaining 60 percent of the industry have no formal fund governance structures in place or they rely on what commentators refer to as the public company model. With this model, a committee of the board of directors of the manager is charged with monitoring the relationship between the manager and the funds. Our governance agency concept excludes the public company model due to the divided loyalties and structural conflicts inherent in this model.

Portfolio management

The approaches taken to portfolio management vary widely within the industry. A large number of the mutual fund managers do all or most of their portfolio management in-house. Some of these managers started out as investment management firms and maintain a wealth-management focus. The majority of mutual fund managers we spoke to have the capacity to do their own in-house portfolio management.

At the other end of the spectrum are those managers who do little or no portfolio management in-house. These managers generally do not have the necessary in-house portfolio management expertise and they outsource this function to portfolio advisers (in some cases to related portfolio advisers).

It should be noted that mutual fund managers often take different approaches to portfolio management for different types of funds. For example, a manager who generally outsources its portfolio management for its equity funds may act as the portfolio adviser for its index or RSP clone funds. Other managers have specialty funds that are marketed as "multi-manager" products.

Distribution systems

Mutual fund managers choose to distribute their mutual funds to the public in a variety of ways. In the most common scenario, the mutual fund manager is also the principal distributor of the funds. As principal distributor, the mutual fund manager is responsible for marketing the funds. While some of these managers may sell direct to the public, the bulk of their funds are sold through the broker-dealer network.

Some mutual fund managers have opted for a vertically integrated distribution structure. Two of the managers we interviewed had purchased a number of dealer firms with the intention of integrating money management with distribution. While both managers provide marketing and systems support, the dealers are described by the managers to be independent because they are not obligated to sell the manager's funds.

A number of the mutual fund managers we spoke to utilise an in-house sales force to sell to the public. The bank-owned managers sell their funds through staff at bank branches. The insurance company-owned managers sell their funds through an exclusive career sales force that is dually licensed as mutual fund sales persons and insurance agents.

Two conventional mutual fund managers we spoke with also sell their funds to the public through their own exclusive career sales forces.

An in-house approach is also used by two other groups of managers, but these managers do not sell to the larger public. The credit union-owned mutual fund managers sell through the credit union branches, but, unlike the bank-owned managers, they sell almost exclusively to credit union members. The professional associations sell directly to members of their respective professional associations only.

We also saw a small group of mutual fund managers that are essentially asset managers that sell directly to a limited group of high net worth clients. While some will sell directly to the public if approached by retail clients, others do not promote or advertise their funds to the public at all. Instead, their funds are only available to friends and family of their high net worth clients who cannot open a segregated account because they do not meet the portfolio manager's minimum thresholds. These funds are only quasi-public in nature.

Purchase options

There is a logical connection between a mutual fund's distribution system and the purchase options it is sold under. Funds can be sold as either "no-load"—which means there is no charge associated with the purchase or redemption of the fund—or they can be sold under a sales charge option.[12] As noted above, no-load funds are not widely offered by dealers and brokers, as these persons generally receive no commission for the sales of these funds.

The following managers offer their funds on a no-load basis: bank- and credit union-owned managers, managers run by professional associations, those managers who sell mutual funds direct to their high net worth clients, and one manager who sells direct to the public using an exclusive career sales force. These managers (with the one exception) have a common element: they all offer mutual funds to their clients as part of a larger cluster of financial services. The banks and credit unions offer integrated financial services to their clients; the professional associations arrange pensions, insurance and investment-type services for their members; and the asset managers offer mutual funds as a means of supplementing their high net worth business.

The majority of mutual fund managers sell their funds under a sales charge option through the broker-dealer network, an in-house sales force (excluding the bank- and credit union-owned managers and the one manager mentioned above), and associated dealer firms.

[12] Sales charges take the form of a front-end sales charge or a deferred sales charge. Investors who choose a front-end sales charge option pay a sales commission when they buy securities of a fund. The commission is a percentage of the amount invested and it is paid to the dealer. Investors who choose the deferred sales charge option do not pay a commission when they invest in the fund. Instead, the mutual fund manager pays the dealer a commission. However, if the investor sells his or her securities within a specified number of years of buying them (usually 7 years), he or she pays a deferred sales charge.

Mutual fund governance: industry experience and attitudes

The discussion above confirms Stephen Erlichman's observation that when it comes to the issue of mutual fund governance; "we are not starting with a clean slate in Canada."[13] Of the approximately 75 mutual fund managers in the country, 28 already have what we would consider to be direct experience with fund governance. These managers spoke positively about the benefits of governance and explored the intricacies of the issues with us. The remaining managers, though lacking in direct experience, were still eager to join the policy discussion. We were particularly interested to hear their questions and concerns. We present what we learned about the industry's experience with, and its attitudes toward, fund governance below.

Will governance agencies add value for investors?

Governance agencies do add value for investors

Ninety percent of the mutual fund managers who have some direct experience with fund governance strongly believe their governance agencies bring value to their mutual fund investors. These managers say their governance agencies offer the following benefits:

- They look out for the best interests of investors, including their long-term interests.
- They bring an ability to deal independently with conflict issues.
- They impose discipline on the manager.
- They oversee and monitor the manager.
- They force the manager to codify informal practices.
- They are a check and balance, a backstop, or a watchdog.
- They encourage a compliance culture.
- They advocate on behalf of investors and forward grass roots concerns.
- They offer advice to the manager.
- They bring another perspective to the table.
- They bring their experience to the table.

[13] Supra note 1 at 19.

- They are a sounding board for the manager.

- They lend credibility to the manager.

- They bring a perception of trustworthiness and integrity.

Many mutual fund managers without any mutual fund governance experience still believe that governance agencies will bring value to investors. This group of managers, which includes both larger and smaller players within the industry, welcomes our general proposal to mandate independent fund governance agencies.

Governance agencies will add little or no value for investors

The most outspoken critics of fund governance are those managers with little prior fund governance experience. The contra-view is that the benefits of independent oversight in the form of a governance agency will not justify their cost. The managers holding this view argue that the fast pace and complexity of the mutual fund industry make it unlikely that truly independent board members will have the requisite understanding of the manager's business to provide effective monitoring. They say the chance of real problems being identified through quarterly meetings, during which board members rely heavily on the manager to provide the necessary information, is very low. According to one critic of mutual fund governance, fund boards are largely cosmetic and while there is nothing wrong with cosmetics, they add little real value for investors.

Governance agencies may add value, but not for our investors

Another group of managers we spoke to believe that, while governance agencies may add value for some investors, they will not add value for their own investors. These managers feel any rules directed at improving fund governance should not be applicable to them.

The bank-owned mutual fund managers tend to tell us that our proposals for improved fund governance will be duplicative for them as they, and the trustees of their funds, are already sufficiently regulated as part of the total bank financial group. Furthermore, they assure us that the oversight provided by the bank structure itself provides greater protection to investors than any board with independent members ever could—particularly because banks are so eager to maintain their own reputations. It is argued that the board of directors of a bank-owned mutual fund manager, populated in part by bank representatives, is more than adequate for our purposes. The CEO of one major bank-owned mutual fund manager asserts that it is the bank representatives on his board, that "keep him honest". Although the banks believe fund governance need not be improved for bank-owned mutual funds, they generally feel traditional mutual fund managers should be subject to some form of independent oversight.

Managers of owner-operated funds tell us that our proposals for improved fund governance should not apply to them because the conflicts of interest these proposals are designed to ameliorate are not present within their structures. Stephen Erlichman agrees

"this structure is perhaps the purest model of aligning the interests of the mutual fund investors with the interests of the mutual fund manager."[14]

Are there any alternatives to fund governance?

A number of possible alternatives to improved fund governance were discussed during our meetings with mutual fund managers. These ranged from changing nothing to adopting the U.S. approach to fund governance wholesale.

Maintain the status quo

A small number of the mutual fund managers we spoke to would have us maintain the status quo. They believe the existing rules are sufficient to prevent any problems from occurring in the mutual fund industry, provided the regulator's compliance and enforcement departments perform their jobs effectively.

An enhanced role for auditors

Rather than have us introduce an independent governance agency, some fund governance detractors would have us increase the role of a fund's auditors. This alternative is based on the understanding that auditors have an intimate understanding of the mutual fund business. One mutual fund manager we met with expressed the concern that governance agencies do not have the ability to "drill down" and find real issues, particularly if the manager is not forthcoming or is unscrupulous. This manager went on to explain that only an audit function could discover real problems. Another manager agreed that the auditors could provide more effective oversight than a governance agency that meets only quarterly.

In contrast to this view, some mutual fund managers told us that their auditors already review most of the important matters pertaining to their funds and they disagreed with the position that there should be an increased role for auditors. One such manager went on to remind us that auditors would increase their fees if given extra duties and predicted that the industry would resist the increased costs.

The auditing firms we spoke with explained to us that auditors with additional responsibilities cannot be a real substitute for a governance agency because good governance requires more than just careful auditing, it also requires the exercise of discretion.

Independent oversight, but at the fund manager level

While some of the managers we spoke with agree there is a need for independent oversight, they argue they can achieve sufficient independence by putting independent directors on their own boards of directors. These fund managers feel their own interests are already sufficiently aligned with mutual fund investors and they believe that independent directors can manage any conflicts of interest that may arise.

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[14] *Supra* note 1 at 106.

The U.S. approach

Our research shows that the approach to mutual fund governance taken by the Securities and Exchange Commission (the SEC) in the U.S. would not be well received in Canada. A number of the mutual fund managers we met with felt the CSA should be wary of taking our cues from the SEC. Many cautioned that the SEC's rules are too complex to transplant into Canada. One mutual fund manager with a U.S. parent agreed that the SEC rules are "way too technical and minute" and explained that this denies U.S. mutual fund directors the flexibility they need to address issues.

The governance principles: industry experience and attitudes

We explain in the concept proposal that each mutual fund manager may decide how to legally structure its own governance agency, so long as that governance agency satisfies the broad standards, called governance principles, established by the CSA.

All of the existing mutual fund governance agencies already abide by many of our governance principles to a greater or lesser extent. This part of the report:

- compares the industry's experience with mutual fund governance to the standards proposed in our governance principles; and

- presents the range of industry views on our specific proposals.

1. Each manager will establish a governance agency

The proposal

We state in the concept proposal that each mutual fund family should have at least one governance agency to oversee the fund manager's management of its mutual funds. We do not propose to specify the maximum number of mutual funds that may be overseen by any one governance agency.

Industry experience

All of the mutual fund managers we surveyed have established only one governance agency to oversee some or all of their funds. In other words, none of the fund families have more than one governance agency, although, technically, fund families with mutual funds structured as corporations, have one governance agency per corporate fund. A board of directors for a corporate fund acts for one fund, but the same individuals may sit on the boards of all the corporate funds managed by the same fund manager. Generally, directors of corporate funds act as directors on the boards of less than 10 mutual funds. The remaining governance agencies tend to oversee a larger number of funds. Eight of the managers surveyed have governance agencies that oversee more than 50 mutual funds. Three of those eight oversee more than 80 mutual funds.

Mutual fund managers with many funds tended to admit that it is a lot of work for their agencies to keep up with a large number of funds. However, we are told that the governance agency for one very large manager successfully deals with well over 100 funds, in part, by placing its reliance on the legwork of staff at the fund manager. Another large fund managers' governance agency effectively oversees over 70 funds by using checklists, charts and summaries to streamline the review process.

Industry views

All of the managers we interviewed were opposed to the prospect of our mandating the use of one governance agency per fund. One fund manager went so far as to say the idea was "ludicrous" because even General Motors has only one board overseeing a hundred different plants. We believe the implication here is that the different mutual funds in a fund family are really quite similar, in contrast to different plants in the example given. Another fund manager likes to draw a colourful analogy between the different mutual funds in its mutual fund complex and the different flavours of ice cream for an ice cream manufacturing company. On the other hand, another mutual fund manager warns us of accepting this analogy because ice cream has set variables, while mutual funds do not.

There appears to be a consensus in the industry that one governance agency will benefit from overseeing a number of funds. In the United States, where each mutual fund has its own board of directors, directors commonly hold multiple seats across a number of funds within a family. According to one study, a significant benefit arises from having common individuals sitting on a number of different boards because it increases their knowledge base and gives them a greater impact on fund operations.[15]

Some of the managers we spoke to admit that one governance agency may not be able to effectively oversee a very large number of funds. For example, a representative from one company with over 50 mutual funds told us it would be "a nightmare" for a governance agency with real duties to oversee that many funds because it wouldn't be able to get into all the relevant details. At the same time, none of the mutual fund managers we saw believe the regulator should specify a cut-off—rather, most managers agreed that fund managers and governance agencies should be given the discretion to decide for themselves what they can and can't handle.

2. The governance agency will be of a sufficient size

The proposal

We propose that each governance agency have no fewer than three individual members.

[15] Tufano P., Sevick M., "Board structure and fee-setting in the U.S. mutual fund industry", *Journal of Financial Economics*, Vol. 46 (3) (1997) pp. 321-355.

Industry experience

All of the governance agencies currently in existence have at least three members. The vast majority (over 90 percent), have more than three members. Governance agency sizes in Canada range from 3 members all the way up to 17 members. The most common board size is five members and the second most common is eight.

Industry views

In one U.S. study, a small board of three to eight members was found to be ideal because a board of this size is large enough to staff its committees and subcommittees without unduly increasing the fees charged to investors.[16]

3. Governance agency members will be independent

The proposals

We propose that a majority of governance agency members be independent of the mutual fund manager. We also propose that an independent member should act as the governance agency chair.

Industry experience

The existing governance agencies have varying degrees of independent representation on them. Roughly 60 percent have a majority of members that are independent of the mutual fund manager while some 40 percent do not. The majority of the governance agencies falling into the second category could easily meet our independence requirement by replacing one related member with an independent or simply reducing the number of related members.

Interestingly, we found that most of the advisory boards have at least a majority of independent members and a number of advisory boards are completely independent of the manager. This may be because the advisory board model is premised on the notion of independent individuals providing advice to the manager.

Industry views

Most of the mutual fund managers we spoke to agree the notion of independence is central to the purpose of our proposed governance agency. Members of the IFIC Fund Governance Committee tell us that the “market is starting to demand independence”. A mutual fund manager that does not have a governance agency explained to us that the media is feeding the market’s focus on independent fund governance.

One manager, whose governance agency lacks independence, believes that independence might, in fact, hamper the effectiveness of governance agencies and argues that internal people have more insight into the operations of the mutual fund manager. This manager went on to say that the addition of independent, external people would only compromise the quality and rigor of the governance discussions. It was also suggested that internal

[16] *Ibid.*

members of the governance agency would be less forthcoming in the presence of "outsiders".

We were told by more than one mutual fund manager that an independent member should be the chair of the governance agency. A corporate governance study has shown that combining the role of board chair and company CEO is problematic because the influence exerted by the CEO tends to reduce the board's effectiveness.[17]

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

The proposal

We state in the concept proposal that the governance agency's role is to ensure the mutual fund manager acts in the best interests of investors by overseeing its actions vis-à-vis the mutual funds. We go on to clarify that the governance agency is to act in a supervisory capacity and is not to interfere with the day to day management of the funds.

Industry experience

Our review of mutual fund disclosure documents demonstrates that the concept of governance agencies safeguarding the best interests of investors is central to mutual fund managers. The words "best interests of investors" are present in more than 20 of the 80 or so mutual fund AIFs we looked at. Of the mutual fund managers with existing governance agencies, 80 per cent indicated that their governance agencies ensure the manager acts in the best interests of investors.

Industry views

The vast majority of the managers we spoke to agreed that "oversight" is not to be confused with "management". However, it is not always clear where oversight ends and management begins. To cite an example, one manager feels strongly that its governance agency should not be in charge of monitoring the performance of its funds, while many others feel this falls squarely within the scope of a governance agency's duties.

5. The governance agency will carry out specific responsibilities

As one might expect, in the absence of a regulatory regime for mutual fund governance, the responsibilities of the different governance agencies in place today vary widely. At one extreme, some governance agencies have only a vague duty to provide advice to the manager. At the other extreme, some governance agencies have a long list of duties that may include acting as the audit committee of the funds, approving the prospectus and financial statements, and reviewing fund performance and management expense ratios.

[17] Collier P., Gregory A., "Audit committee activity and agency costs", *Journal of Accounting and Public Policy*, Vol. 18 (4-5) (1999) pp. 311-332.

a. Meet regularly with the manager

The proposal

We expect each governance agency to meet regularly with the mutual fund manager.

Industry experience

Most of the governance agencies we surveyed meet at least quarterly. Only four of the 28 governance agencies meet less than 4 times a year. Some of the governance agencies met eight times in the last year and one governance agency met once a month.

b. Identify material policies and procedures

The proposal

Each governance agency will be expected to determine which policies and procedures of the fund manager are material to investors. If the fund manager does not have any specific written policies and procedures, the governance agency will ask that these be developed.

Industry experience

Internal policies, practices and guidelines are an integral part of most managers' fund governance mechanism. Of the 70 managers in our database, only 11 stated that they have no policies, practices or guidelines in place. The remainder made explicit reference to at least one policy, practice or guideline, although often this one policy or guideline was an industry developed code of ethics, and not the types of policies and procedures we list in the concept proposal.[18]

c. Monitor compliance with policies and procedures

The proposal

We propose that each governance agency monitor the mutual fund manager's compliance with its policies and procedures.

Industry experience

Over 70 percent of the existing governance agencies already approve and monitor certain policies and procedures of the mutual fund manager.

d. Consider and approve benchmarks

[18] A significant number of fund companies rely on policies, codes or guidelines established by an industry group. A large number rely on the IFIC Code of Ethics for Personal Investing while a handful use the AIMR Code of Ethics and Standards of Professional Conduct, the ICAC Code of Ethics in the Statement of Function & Principles of the Professional Investment Counsel, or the IDA Code of Conduct.

The proposal

We will require each governance agency to consider and approve the mutual fund manager's choice of benchmarks against which fund performance will be measured. Governance agencies will also measure fund performance against these benchmarks.

Industry experience

Almost 80 percent of the existing governance agencies already monitor the performance of their mutual funds against benchmarks.

e. Act as the audit committee

The proposal

We will require each governance agency to act as an audit committee and approve the financial statements of the funds.

Industry experience

Over 60 percent of the existing governance agencies act as an audit committee and approve the financial statements of the funds. Many of these audit committees are independent. One mutual fund manager has its audit committee meet with the funds' auditors without management present.

According to our review of fund governance disclosure, it appears that an audit committee may have some, or all, of the following responsibilities:

- reviewing the operations of the fund
- ensuring policies are maintained
- reviewing the risk profile of the fund
- evaluating systems of internal controls and reporting procedures.
- reviewing the annual financial statements
- reviewing the results of the external auditors' review of the financial reporting process and to report any unresolved issues to the board of directors
- making recommendations to facilitate improvements to the financial reporting.

Industry views

One corporate governance study has shown that audit committees, composed entirely of independent directors, are more effective at reducing agency costs—a prime consideration for mutual funds.[19]

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

[19] *Supra* note 15.

The proposal
Governance agency members will be required to exercise their 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. Members of a governance agency will only be liable for investor losses if those losses result from a failure of the governance agency to discharge its duties in accordance with the standard of care.

Industry experience
Because of corporate statutes, the members of a corporate mutual fund's board of directors are clearly subject to a standard of care. The issue is not as clear-cut in the context of mutual fund trusts. Our survey found that just over half of the mutual fund managers with governance agencies for their mutual fund trusts believe their governance agency members attract potential legal liability for their actions. Just under 50 percent believe that governance agencies for mutual fund trusts have no such potential liability. We believe one of the benefits of our proposals for improved fund governance is that it will clarify this issue and ensure consistency throughout the industry.

Industry views
Liability of the members of the proposed governance agency was one of the most controversial topics we broached with the mutual fund managers we interviewed. Not surprisingly, there was no consensus view on this issue—in fact, many of the managers spoke at cross-purposes. We found that there was a general lack of understanding of what standards of care in this context means. Certain managers spoke about the benefit of having a "deep pocketed" governance agency, such as a registered trust company. Other managers worried that any liability attaching to a governance agency will dilute, or be duplicative of, the manager's liability. Both of these ideas are not consistent with the kind of standard of care we envision for members of a governance agency. Any liability on the part of the governance agency members would not detract from that of the fund manager in the event of a loss for which the fund manager is responsible. The purpose of requiring members to follow a defined standard of care is to ensure that members of that governance agency take responsibility for their actions.

A number of the managers told us personal liability for governance agency members is not necessary because risk to their reputation is a greater motivator than the risk of financial loss. We note that the members of the current governance agencies are often experienced business people with excellent reputations. On the other hand, one manager insisted that liability is necessary for its governance agency to "do its job".

7. Appointment of the governance agency members

The proposal
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 remaining governance agency members will fill vacancies on the governance agency. Disclosure to investors about governance agency appointments and resignations will be required.

Industry experience

With one exception, every mutual fund manager with a governance agency appointed the initial members of that agency. One mutual fund manager had its investors ratify its initial member choices at a special meeting. Mutual funds structured as corporations, either hold annual meetings to permit investors to elect a slate of directors, or have the mutual fund manager, as holder of the voting common shares elect them. In either case, corporate law dictates how boards of directors of corporations are elected.

Vacancies on governance agencies for trust funds are currently filled in a number of ways:

- manager appoints new members (50 percent)
- governance agency appoints new members (18 percent)
- manager nominates new members and governance agency appoints them (18 percent)
- governance agency nominates new members and manager appoints them (3 percent)
- investors ratify new appointments at special meeting (7 percent)
- external body appoints new members (3 percent)
- independent trustee appoints new members (3 percent)

Industry views

The industry did not have very much to offer us on the appointment of governance agency members. While most managers agreed that an election by investors is the most obvious approach, most of them also pointed out that investor apathy, coupled with the fact that most governance agencies will oversee more than one fund, make this impractical.

According to most of those we spoke with, appointment by the manager with disclosure of the choices to investors is a more practical solution.

8. Compensation of the governance agency members

The proposal

We propose to allow each governance agency to set its own compensation, which can be paid out of fund assets, provided certain disclosure to investors is given. Fund managers will have a "veto" in case of perceived unreasonable levels of compensation.

Industry experience

The compensation paid to governance agency members ranges from nothing to $30,000 per annum. The average per annum fee is between $15,000 to $20,000. Almost 30 percent of the managers surveyed do not pay their governance agency members, because the governance agency positions are voluntary or the members are otherwise

compensated as employees or officers of the mutual fund manager. None of the mutual fund managers included in our survey offer mutual fund units or shares to their governance agency members as part of a compensation package.

Only 2 of the 28 governance agencies set their own compensation. Another two set their own compensation in conjunction with the manager. The remaining managers set the compensation for governance agency members.

More than half of the managers surveyed indicated that fees and costs are paid out of fund assets—the remainder pay the fees and costs of the governance agency themselves.

Industry views

One mutual fund manager suggested that governance agency members and the manager should jointly approve compensation. This manager pointed out that U.S. fund directors tend to "jack-up their own fees". They went on to conclude that we must give the manager some "blocking-power".

The majority of managers we asked believed that members of the governance agency should be compensated out of fund assets rather than by the manager. This is said to be logical because the governance agency is really there for the investor. It also avoids a conflict situation where the governance agency might be swayed towards the fund manager due to the compensation the manager is paying the members.

One manager urged us to consider requiring members of the governance agency to be compensated in units of the funds they oversee. This, it was argued, will align their interests with those of investors.

9. Dispute resolution

The proposals

If a governance agency's disagreement with the mutual fund manager cannot be otherwise resolved, 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 go to investor meetings, it must tell investors about any unresolved dispute and how it proposes to deal with it. The governance agency will not have the power to terminate the fund manager's appointment as manager, without authorization from the investors.

A fund manager may decide that the governance agency for its mutual funds or an individual member is 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 investors terminate the appointment of governance committee members and elect new members.

Industry experience

More than 60 percent of the managers surveyed indicated that they have never disagreed with their governance agency. The managers who have had such disputes tell us these are always resolved after discussion between the manager and the governance agency. None of the existing governance agencies have put disputes before investors, either at a meeting or in a written communication; however, one governance agency has threatened to go to investors with unresolved issues.

Industry views

The mutual fund managers we spoke to almost unanimously believe our proposed governance agency should not have the power to terminate the manager. Only one manager questioned whether a governance agency without this avenue of recourse would "lack teeth". The arguments against allowing the governance agency to fire the manager are summarized as follows:

- Investors are purchasing the manager's expertise as much as they are purchasing a product and they would be very surprised to find their fund was no longer managed by that fund manager.
- Practically speaking, a governance agency simply would not fire the manager without authorization from investors.
- A "kooky" or "belligerent" governance agency with "its own agenda" should not have this kind of power.

The ability to call a meeting of investors, though not as vehemently opposed as the ability to fire managers, also received mixed comments. A manager with a well-established governance agency explained that their governance agency would resign before a dispute could ever be brought before investors. Other managers agreed that business reality would prevent this avenue of recourse from being pursued. Many managers told us the ability to call investor meetings is not meaningful or practical because nobody ever attends these meetings and "you need to beat the bushes to get a quorum". One manager reminded us that investors invest in mutual funds precisely because they don't want to be bothered overseeing their investments – "you are asking them to do something they don't want to do when you call them to meetings".

Some managers told us the ability to issue a press release or notify the regulator of a problem is a sufficient avenue available for governance agencies to resolve disputes with fund managers. Another manager said it is enough that the governance agency be entitled to consult with independent counsel. A large number of managers felt the resignation of governance agency members would send a powerful message to the public and as such, the CSA did not need to mandate any specific dispute resolution.

10. Reporting to investors

The proposal

We propose that investors receive point of sale disclosure of the name and background of each governance agency member, the compensation paid to governance agency members and the responsibilities of the governance agency. We also propose that they receive annual reports from the governance agency including information on the activities of the governance agency, any changes in its membership and compensation, its assessments of its performance, and any unresolved disputes between the governance agency and the mutual fund manager.

Industry experience

We were surprised to learn that two of the mutual fund managers surveyed tell their investors absolutely nothing about their governance agency (given the AIF requirements of NI 81-101, this is particularly surprising). The vast majority, on the other hand, do make some disclosure. More than half of the mutual fund managers we saw put the names of their governance agency members in the AIF for their funds. Just less than half of the managers disclosed the compensation paid to their governance agency members in an AIF. Almost 60 percent of the mutual fund managers surveyed describe the mandate of their governance agency in an AIF

Three of the existing governance agencies provide an annual letter or information notice to investors. Three others noted that their annual report contains information about their governance agencies. Of the managers surveyed, 50 percent have had members resign in the past, but investors were informed in only 15 percent of those cases.

Industry views

The managers we spoke to unanimously agreed that investors should be informed about the governance of their mutual funds. Reporting to investors is significant because it creates a nexus between the governance agency and investors.

Registration of mutual fund managers: industry experience and attitudes

On the registration of fund managers "pillar", we saw much more uniformity in the views expressed. Every manager agreed that minimum standards of some sort should be imposed on fund managers and they agreed that registration is an appropriate tool to accomplish this. In fact, some voiced the opinion that it is "high time" managers get registered.

The only real caveat being that the new registration system should not be duplicative or arcane. IFIC's Fund Governance Committee suggested that mutual fund managers should only be required to register in one jurisdiction. Managers who are already

registrants should be able to simply "check-off one more box" on their annual registration.

Minimum proficiency

One fund manager told us that every mutual fund manager needs at least 3-4 people who will: (a) act as CEO and who has the qualifications of an entry-level fund manager; (b) act as CFO – who has a financial background; (c) handle compliance; (d) look after administrative matters and customer service; and (e) look after fund accounting.

Ability to monitor third-party service providers

A fund manager told us that even if certain functions are out sourced to third-party service providers, the mutual fund manager should have sufficient qualified staff to monitor these functions. Another echoed this comment: "sufficient competencies are required within the fund manager to enable it to effectively oversee the activities of service providers". Another fund manager suggested that we think about two levels of registration with different proficiency requirements for "virtual" managers versus full service managers.[20]

Minimum capital requirements

Thoughts on whether fund managers should be subject to minimum capital requirements were quite equally divided. Some insist that minimum standards for mutual fund managers must include capital requirements. This is so that investors may have some comfort that there is enough money available to address manager risk. A "deep pocket" must be available to adequately compensate investors in the case of loss. Those in favour of capital requirements say that managers need sufficient capital to cover the operating expenses of their funds for at least five years in the event the funds gets little business. Smaller mutual fund managers expressed the concern that minimum capital requirements could put them out of business. At the same time, a relatively new entrant into the fund business reminded us that new mutual fund managers already need a substantial amount of capital to enter the market. These fund managers advised us not to concern ourselves too greatly with creating barriers to entry for smaller mutual fund managers as non-regulatory barriers are already significant and serve, in a practical sense, to keep mutual fund managers under a certain size out of the industry.

Re-evaluation of product regulation: industry experience and attitudes

The third pillar of our renewed framework is the one that has most fund managers excited. Those mutual fund managers with related underwriters or that are part of a financial group see this commitment to re-evaluate product regulation as a solution to their problems with the current conflicts regime. They see independent fund governance

[20] "Virtual" managers are managers who have outsourced all essential functions to third-party service providers. These managers are often "one-man-shows", run by a founding entrepreneur.

as the only practical solution for the problems they are experiencing with our current conflicts regime.

While most of the industry sees the relaxation of the existing product regulation as the “sugar on the pill”, a small group of mutual fund managers are not convinced the CSA can or should re-evaluate the detailed rules in NI 81-102. For the most part, these managers would prefer not to swallow the pill at all because they are not proponents of fund governance or relaxation of the product regulation. Interestingly, these managers tend to prefer the certainty of set product regulation and they are not convinced the existing rules should be relaxed.

Others we spoke with felt that “removing portions of the existing regulation will only open up more risk”. One fund manager with a governance agency in place, is “skeptical of how much we can take off the table”. It feels it is important to maintain the “rule of law” and warns us that the same people who are pushing for more flexibility may come to us later for guidance on these very matters. Another fund manager expressed concerns about whether independent governance agencies would be qualified to address conflicts.

Proposed framework for cost-benefit analysis

The need for a cost-benefit analysis

Economists use cost-benefit analysis as a complementary tool for decision making and also to communicate reasons for policy changes or decisions. Through a cost-benefit analysis, economists can estimate the costs of an initiative and compare those costs to the estimated benefits. Some costs and benefits are easy to quantify—that is a dollar figure or dollar range can be estimated. In this case, a quantitative, or numerical, analysis can be completed. Other costs and benefits are more subjective and are difficult, or even impossible, to quantify. In this case, a qualitative analysis is used.

We know that the costs of improving fund governance and the regulation of mutual fund managers must be proportionate to the significance of the regulatory objectives we seek to realize.[21] To ensure that we do not impose unjustifiable costs on the mutual fund industry and investors, the OSC’s chief economist will prepare a quantitative cost-benefit analysis of our proposals. This quantitative analysis will supplement the qualitative benefits we cite in concept proposal in support of our renewed framework for regulating mutual funds and managers.

We have information about costs, but little numerical data of benefits

We know from our industry consultations that the costs attached to the CSA’s proposed renewed framework of regulation are a matter of some interest and concern. For this reason, our chief economist has estimated, on a preliminary basis, the costs of creating

[21] See section 2.1 of the *Securities Act* (Ontario).

and operating a governance agency of the nature we propose. We outline his preliminary findings below.

The benefit side of a cost-benefit analysis is almost always more difficult to define than the costs. This is particularly true in our case—mutual fund governance represents an important shift in our regulatory strategy and although, we believe it will be accompanied by qualitative benefits, these benefits will likely be very difficult to quantify. Benefits of our proposals may relate to prevention of negative outcomes which, given that they have not yet occurred, cannot be readily quantified. For example, how does one quantify the costs versus the benefits of buying a fire extinguisher? We cite a recent OECD paper in the concept proposal (see footnote 8). The authors of that report have an interesting perspective on this issue:

> The OECD countries have used a variety of governance structures in the CIS [collective investment schemes or mutual funds] sector. The fact that very few countries have had any crises in the CIS sector and that CIS have become major repositories of wealth would suggest that existing governance mechanisms are adequate and that public confidence is high. At the same time, the fact that fraud and misallocation of funds occurred in several European countries before the introduction of adequate legal frameworks and that a serious systemic crisis arose in Korea, where adequate standards were not effectively enforced, provides evidence that such safeguards are needed. At the same time, once a body of acceptable standards has developed and governance structures mature to the point that those assigned an oversight role can compel participants to apply those standards, it becomes very difficult to demonstrate that any particular system provides better investor protection than others.

We expect to be able to articulate some quantitative benefits that will come from our proposals. We outline the kind of analysis our chief economist will carry out in this report. We invite your comments on our proposed cost-benefit analysis.

The costs of improved fund governance

The cost estimates for mutual fund governance were relatively easy to define. We began by looking at what it costs mutual fund managers with existing governance agencies to operate those governance agencies. These operational costs were based on the information we received from our survey of mutual fund managers with existing governance agencies. Although these governance agencies are not identical to the structures we propose, some of the costs associated with running them should remain constant. We further refined our estimates by looking into the costs associated with boards of directors of Canadian corporations. Finally, we cross-checked our cost estimates with available evidence from the U.S. Our cost estimates always err in favour of the upper range—we would rather over-estimate the costs, than under-estimate them.

Explanation of our cost analysis

We make a number of assumptions in this analysis:

1. A universe of 80 mutual fund managers in Canada, of which 35 are "large" managers and 45 are "small" managers. Large fund managers are those with assets under management of greater than $2 billion. Small fund managers are those managing assets under $2 billion.
2. Large managers will have boards made up of 12 members (11 directors + 1 chair per board). This number reflects the average board size for Canadian corporations. Small managers will have three member boards (2 directors + 1 chair per board). This number reflects the minimum proposed requirement.
3. $411 billion in assets under management by the total mutual fund industry. This figure is the assets under management total as of the date of our survey (July 2001). The 45 small managers have 3 percent of this total.
4. Currently, the mutual fund managers with governance agencies are spending $4.2 million a year to run them. This figure is based on the data derived from our survey.
5. The mutual fund industry currently incurs $5.0 billion to cover total expenses (fund manager expenses). This figure is derived from a review of fund manager financial statements (filed with the Commission) and includes expenses that may be charged to the mutual funds. Not all of these total expenses may be charged to the mutual funds. Small fund managers incur $226 million of fund manager expenses.

The following elements form the basis of our estimate of the one-time costs of setting up a governance agency:

- Average executive search costs for a board of directors: $149,514 (range: $120,000-$179,027)
- Legal fees, including fees for amending constating documents: $75,000

The following elements form the basis of our estimate of the annual costs of running a governance agency (total annual governance costs):

- Average total compensation per director: $46,249-$72,199
- Average total chair compensation: $148,054

  The director and chair compensation estimates are based on the following elements:
  - Average director retainer fee: $25,000
  - Average fee per meeting: $1,000-$1,300
  - Average fee per committee member: $4,000
  - Average fee per committee chair: $6,000

- Average director's liability insurance: $112,500 (small manager) - $300,000 (large manager)
- Other associated operational and administrative board costs: $30,000
- Annual fees for independent legal advice: $75,000

The estimated total one-time set-up cost for the industry is: $17.9 million

The estimated net* total annual governance costs for the industry are:

- All managers: $65.9 million
- Small managers: $21.6 million

*This amount is net of what the industry is already spending to operate governance agencies.

Total annual governance costs as a percentage of industry assets:

- All managers: 0.016 percent
- Small managers: 0.178 percent

Total annual governance costs as a percentage of fund manager expenses:

- All managers: 1.3 percent
- Small managers: 9.5 percent

The costs of our proposals for improved fund governance on an annual basis (after payment of the initial one-time set up costs) will represent 1.3 percent of fund manager expenses and 0.016 percent of 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.

For the small mutual fund managers in Canada (managing 3 percent of the industry's total assets), potential annual governance agency costs will average 9.5 percent of the fund manager expenses currently incurred by those fund managers or 0.178 percent of assets under management by those fund managers. Although we recognize these costs will represent a significant addition to the start-up costs for new mutual fund managers, this additional outlay should not present an insurmountable obstacle for these managers.

Our chief economist cautions that a cost-benefit analysis applies primarily to actively managed mutual funds where profit margins tend to be wider and there is greater scope for conflicts between the investors' interests and that of fund managers. Positive benefits versus costs may not be as apparent for those mutual funds where margins are thinner and conflicts are minimized.

For passively managed mutual funds, in particular, where fund management expenses can run under 20 basis points, the potential for significant savings to investors in these funds is limited. Adding additional costs to these funds is unlikely to generate significant net savings and could, in the case of smaller mutual funds, make them uneconomical to run. A similar situation could exist for fixed income funds. The range of performance in these funds, from top quintile to bottom quintile is very narrow. Similarly, the risk- adjusted return to investors in these funds is much lower than in actively managed funds.

For a large family of mutual funds, governance agency costs could be apportioned across mutual funds according to the degree of risk of those funds. This would result in a much lower charge to index, money market and other fixed income mutual funds, which would improve the cost-benefit ratio for these funds.

The quantitative benefits to be included in our analysis

Our chief economist will be reviewing the following benefits for Canadian mutual funds, among others, to develop a quantitative cost-benefit analysis.

Improved fund governance may reduce costs for investors

Some commentators have suggested that governance agencies may operate to lower, or at least limit, increases to the fees charged to investors. We will investigate whether there is merit to this assertion and attempt to quantify any such benefit.

Canadian mutual funds may benefit from carrying out previously prohibited related party transactions

Substantial benefits to investors and the industry may arise from the relaxation of the conflict of interest provisions under our improved governance regime. Mutual funds will be able to take advantage of certain related-party transactions that are currently

prohibited. Mutual fund managers will also be able to avoid legal and regulatory fees associated with preparing applications to ask the regulators for permission to carry out these transactions. As we move forward with our proposals we will provide an analysis of these and other potential benefits.

Canadian mutual funds may gain access to international markets

We note in the concept proposal that Canada is one of the few remaining countries in the world that does not mandate some form of independent mutual fund governance. We also note that reforming our regulation to make it consistent with international standards may improve the Canadian fund industry's reputation and may afford Canadian mutual funds easier access to international markets where foreign mutual funds are welcomed such as Hong Kong. We will analyze any potential benefits for the Canadian industry, keeping in mind that Canadian mutual funds may gain access to international markets at the competitive expense of international funds entering the Canadian market.

Outcomes of our empirical research

Our empirical research has led us to a number of significant realizations. As a consequence, we believe that the renewed framework proposed in our concept proposal is very much in touch with the practical realities of the Canadian mutual fund industry. What follows is a brief summary of the outcomes of our research.

The industry accepts the need for improved fund governance

Mutual fund governance is not a new concept for mutual fund managers. In fact, more than a third of the industry has already adopted some form of governance agency voluntarily. There is widespread agreement among the managers with governance agencies that their governance agencies add value for investors. The remainder of the industry, though lacking in direct experience, is already familiar with the concept of independent oversight. Many managers without governance agencies agree that regulation in this area is overdue. The market is starting to demand good governance and even the most reluctant mutual fund managers accept that independent governance agencies might be a good marketing tool.

A one-size-fits-all approach is untenable

The mutual fund industry in Canada is diverse. Our market supports mutual fund managers of all shapes and sizes. The business of a conventional mutual fund manager bears little resemblance to that of a bank-owned mutual fund manager, a "virtual" fund manager, or a professional association that offers mutual funds to its members. A one-size-fits-all solution is not ideal for in an industry such as ours. Instead, we have chosen to capture the essence of improved fund governance in broad governance principles that can be applied flexibly to suit each mutual fund manager's business needs.

The costs of improved fund governance will not be prohibitive

Our preliminary cost analysis shows that the costs of creating and operating a governance agency will not be prohibitive.

A registration regime for mutual fund managers is long overdue

The Canadian mutual fund industry is in favour of mutual fund manager registration. Many described the current absence of manager registration as a gap in the regulation that needs to be filled. The only concern is that we craft an efficient and effective regime.

Loosening of the current conflicts regime is much anticipated

The vast majority of industry participants await the relaxation of our current related-party prohibitions. Many mutual fund managers who are not yet convinced of the benefits of improved mutual fund governance are willing to adopt governance agencies if it means the conflicts and other product regulation will be reassessed.

The industry is ready to comment on our proposed renewed framework

Many in the industry have noted that our concept proposal is long overdue. We discussed concepts with industry participants that have been suggested for years, but not acted upon by the regulators or the industry at large. The industry welcomes our continuing the debate and wants to understand the details of our proposed requirements. We can expect solid participation and feedback from industry participants and IFIC through our comment process.