Appendix B

Concept Proposal 81-402
Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers

Summary of Comments and Response of the Canadian Securities Administrators

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BACKGROUND

On March 1, 2002, the Canadian Securities Administrators (the CSA) released Concept Proposal 81-402 *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers* (the Concept Proposal) for public comment. The Concept Proposal outlined our renewed vision for mutual fund regulation in Canada and detailed our proposals to improve mutual fund governance and introduce a registration requirement for mutual fund managers.

The comment period for the Concept Proposal ended on June 7, 2002, however we did consider a number of late submissions. We received 57 comment letters in total.[1]

A list of respondents is set out in **Appendix 1**. All comment letters have been posted on the website of the Ontario Securities Commission (the OSC) (www.osc.gov.on.ca). We are pleased at the healthy response to our request for comments, and we wish to thank all of those who took the time to comment.

HOW TO READ THIS DOCUMENT

This document summarizes the public comments we received on the Concept Proposal and describes how these comments influenced the next iteration of our proposals for regulatory reform, Proposed National Instrument 81-107 Mutual Fund Governance (the Proposed Rule) and its Notice.

Although we use the phrase "governance agency" throughout this document so as to be consistent with the Concept Proposal, we are now referring to this body as the "independent review committee".

SUMMARY OF COMMENTS AND RESPONSES

Our vision for mutual fund regulation

The five-pillared framework

Public comments

On the whole, the proposed five-pillared framework for mutual fund regulation received favourable comment. We received strong support for our treatment of mutual fund regulation as a total package, rather than simply introducing new regulation on top of old in a piecemeal fashion. The comment letters underscored the importance of our re-evaluating the existing regulation concurrently with the introduction of fund governance and mutual fund manager registration.

[1] The parties represented add up to more than 57 because one investment manager is also counted as a mutual fund manager and one letter was written by a law firm on behalf of a mutual fund manager.

Most of the respondents wholeheartedly agreed with our critical assessment of the existing regulation. The letters echoed our sentiment that the current prohibition-based approach to regulating conflicts of interest is too restrictive on the one hand—because it prohibits innocuous or beneficial transactions—and not inclusive enough on the other—because it fails to address certain conflict-driven problems. One letter stressed that many innovative products are delayed or fail to come to market at all due to the current regulatory restrictions. The existing rules were widely described as being complex, restrictive and outdated.

Although our overarching goal of providing more flexible regulation was universally lauded, not everyone agreed that our proposed framework would get us to that end. We received some very positive comments on our proposal to replace the prohibition-based approach to conflicts with an approach that relies upon the discretion of independent governance agency members, but we also received comments that went in other directions. A small group of respondents would not have us regulate conflicts at all because they believe the interests of fund managers and investors are almost completely aligned. They reminded us of the safeguards built into mutual fund investing and pointed out that there is little evidence of any problems. Another small group suggested the current regulatory framework is fine as it is and one or two of that group even stated a preference for the certainty offered by its bright line tests. Still another group of respondents informed us we have not made the case for the kind of regulatory changes proposed, particularly given their potential cost to investors and the industry.[2] A number of the letters called for more detail on our proposals, particularly in the area of product regulation.

CSA response

We are confident that our five-pillared framework for mutual fund regulation is a sound blueprint for change. We believe each pillar has an important role to play in ensuring our regulation of mutual funds and their managers meets the needs of our industry and is consistent with international standards. At the same time, we understand that we cannot bring all five pillars into place overnight.

We agree with the respondents who urged us to re-evaluate the existing conflicts of interest rules concurrently with the introduction of fund governance. The fund governance regime set out in the Proposed Rule is designed to replace the conflicts of interest prohibitions in the existing regulation.

Although we continue to believe mutual fund managers should be registered, we do not elaborate on this pillar in the Proposed Rule because we wish to await the outcome of other policy initiatives that may change the way we approach registration issues.

I. Mutual fund governance

[2] The comments on the costs of our proposals are summarized at the end of this paper along with the comments on the cost-benefit analysis.

The governance agency concept: A flexible approach to implementation

Public comments

Our proposal to allow each mutual fund manager some flexibility in the design of its own governance agency, so long as it abides by our ten governance principles, met with almost unanimous approval. According to respondents, an approach that gives fund managers some flexibility is preferable to our mandating a single legal structure for all governance agencies because it will allow managers to design cost effective, yet functional, governance agencies. Interestingly, the only dissenting voice belonged to an existing governance agency. This governance agency championed the view that a single legal model is preferable because it is consistent with corporate practice and easier for the investing public to grasp.

A few respondents raised questions about the legal implications of such a flexible approach. We were asked to clarify how the requirements of trust law, corporate law and securities regulation would come together to create a consistent approach for all governance agencies, regardless of the legal form they take. We were also asked to clarify how the duties of care belonging to the governance agency, mutual fund manager and trustee would fit together. One respondent expressed some concern about the fact that the governance agencies for mutual fund trusts, unlike those for mutual fund corporations, will not be built on an already established body of law and practice. This fact might lead to some uncertainty, they told us.

CSA response

We continue to believe a flexible approach is tenable. Although we appreciate the simplicity of an approach that requires all mutual funds to be organized as corporations governed by a board of directors or trusts with individual trustees, we believe the benefits would not outweigh the costs. With a flexible approach, the consistency comes from substance, rather than form.

The board of directors of the fund manager as governance agency

Public comments

Our argument that the governance agency for a mutual fund trust should not be the board of directors, or a committee of the board of directors, of the fund manager, or the shareholder(s) of the fund manager, met with more support than not. A large majority of the respondents acknowledged that where a fund manager's board actively governs the manager with a view to a profit, that board cannot provide truly independent fund governance. On the other hand, we also heard from a few respondents who believe the manager's board of directors is well suited to carry out governance work because it has an interest in ensuring excellence in this area.

We received a more divided response to our proposal to allow the board of directors of the manager of "owner-operated" mutual funds to act as the governance agency. A number of respondents, including a couple of managers of owner-operated funds, agreed with our assertion that the interests of the fund manager and investors in an owner-operated structure are aligned. A

slightly larger group of respondents, including some of the larger conventional fund managers and bank-owned managers, strongly disagreed. They reminded us that not all investors in owner-operated mutual funds are shareholders of the manager and, even when they are, these investors often own the manager indirectly and lack the tools to ensure their interests are served. The same level of protection should be provided by all funds, we were told.

CSA response

The governance agency is specifically designed to address conflicts between the interests of the fund manager and investors; therefore we believe the board of the fund manager cannot fulfil this role due to its inherent conflict. The arguments against the board of directors of the manager of "owner-operated" funds acting as a governance agency were persuasive.

Accordingly, the proposed regime requires all members of the governance agency to be independent of the manager and members of the board of directors of the fund manager will not be allowed to act as the governance agency.

The board of directors of a registered trust company as governance agency

Public comments

Our suggestion that the board of directors of a registered trust company could act as a governance agency was met with varying reactions. One mutual fund manager has had good experience with this structure. Other respondents, however, were skeptical about this approach. They pointed out that the board of directors of a registered trust company is just as conflicted as the board of directors of the fund manager because the directors owe a legal obligation to someone other than the mutual fund investors. We were also warned that where the trust company is owned by the shareholders of the fund manager, persons nominated as external directors may not be as independent as one would hope.

CSA response

Although we understand the arguments against allowing the board of directors of a related trust company to act as the governance agency, we believe this approach can be workable so long as the board is sufficiently independent.

Governance principle 1. Number of governance agencies to be established

Public comments

Although most of the respondents on this point agreed there would be a practical limit to the number of mutual funds that one governance agency can oversee effectively, they felt this determination should be left to the discretion of the mutual fund manager and the governance agency.

We were informed that mutual fund managers tend to manage their funds in a common manner. For this reason, many respondents felt that one governance agency could oversee all of the funds in a fund complex, provided its role, responsibility and liability is sufficiently circumscribed. Some respondents pointed out that one governance agency will be in an ideal position to analyze inter-fund conflicts across a fund complex.

CSA response

After reviewing the comment letters, we do not believe we need to specify the maximum number of funds that may be overseen by one governance agency. We believe this is an area that may be governed by industry practice standards.

Governance principle 2. Size of governance agency

Public comments

Few letters commented on our proposal to allow no fewer than three individuals to serve on a governance agency. One respondent simply stated that five or more members would be preferable while another told us that three to eight members is ideal.

CSA response

For practical reasons, we believe a governance agency should have at least three members. We leave it to the discretion of the mutual fund manager and the governance agency to determine how many additional members are required for each governance agency to function optimally. Again, this is an area that may be governed by industry practice standards.

Governance principle 3. Independence of members

Public comments

The proposed definition of independence was acceptable to most respondents,[3] however some felt the definition should be narrowed while others felt it should be broadened. We heard arguments for and against various parties being allowed to participate as independent members of a governance agency.

A couple of respondents expressed concern that the words "or could reasonably be perceived to" in the definition of independence includes a subjective element and thus gives rise to uncertainty.

Our suggestion that a majority of the governance agency members be independent of the mutual fund manager received some positive feedback but a myriad of other views were also heard on this point. One person said that all members should be independent. This person would make management representatives ex-officio members without voting rights. Many more respondents took the opposing view based on the assumption that management participation in the governance agency would assist it to execute its roles and responsibilities. Two comment letters

[3] A member is independent of the fund manager if he or she is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially influence the member's oversight of the mutual fund manager's management of the mutual fund

suggested that two-thirds independence would strike a better balance of power than a simple majority. A number of smaller mutual fund managers argued that independent governance is not necessary for small managers because they have fewer potential conflicts. We were also asked to leave the question of independence to the mutual fund manager to decide. Some respondents forwarded the view that truly independent people do not have the requisite knowledge of the industry and the fund manager's business to pass judgment on management.

We received little feedback on our suggestion that the governance agency chair be independent.

CSA Response

Independence is central to the role of the governance agency and we believe that all members must be independent of the fund manager if the governance agency is to resolve conflicts of interest.

Governance principle 4. The governance agency's role

Public Comments

We were told that the governance agency's role should be clarified. The meaning of the words "best interests of the fund and its investors" must be better explained. The role must not be cast too broadly and should not overlap with or detract from the role of the mutual fund manager. The governance agency should not "supervise" because the supervisory role belongs to management at corporate law. Likewise, it should not act as a "board of directors" of a mutual fund. The governance agency should not oversee the strategic direction of the fund or micro-manage the day-to-day management of the mutual funds.

Some commenters felt that the governance agency should act as the representative of unitholders. It should focus on areas where it can add value to the unitholders it represents.

CSA response

We agree with these comments and have significantly narrowed the role of the governance agency. Its role in the Proposed Rule is to ensure that the fund manager's actions achieve a fair and reasonable result for the mutual fund, and that, where the manager's interests are potentially different from, or conflict with, the interests of the mutual fund, this conflict does not inappropriately influence the manager's actions.

Governance principle 5. The governance agency's minimum responsibilities

Public Comments

Some respondents liked the fact that we would only set a minimum mandate and allow each governance agency the flexibility to decide what other responsibilities are appropriate to it. Others were worried that this flexibility would leave governance agency members free to expand their mandate and micromanage the fund. They also suggested that this could result in a lack of rigor, fragmentation in the market, and investor confusion. A number of respondents asked us

for a fuller explanation of the responsibilities and one asked us to supplement the description of responsibilities with a list of matters that are not the responsibility of the governance agency.

We saw a number of overarching themes in the comments on each of the specific responsibilities. We were told that the governance agency should not:

- duplicate the efforts of any other party, including the fund manager, the portfolio adviser, internal audit or internal compliance.

- interfere with management or engage in micro-management.

- be asked to do things that it is not well-positioned or equipped to do.

We also received the following comments on each of the specific responsibilities:

a. Meet with and receive information from management

Although our suggestion that the governance agency meet regularly with management was not controversial, a small group of respondents expressed a preference for ad hoc meetings rather than meetings on prescribed dates. One respondent asked us to clarify that the governance agency can meet with management outside of its regularly scheduled meetings to bring matters to the attention of the manager, while another asked us not to grant unlimited access to the manager. Although we were reminded that the manager should have a positive obligation to co-operate and provide whatever information the governance agency may reasonably request, we also heard concerns that the governance agency would overwhelm the fund manager with requests for studies, research, and arcane data.

b. Oversee development and compliance with policies and procedures

The overwhelming majority of respondents on this point told us the governance agency should not be asked to approve policies because they do not have the know-how to do this and because it could lead to micro-management, duplication of work, and unnecessary expense. We were reminded that boards of directors are not asked to approve policies because this job belongs to management and management's professional advisors. We were asked, "why not have the governance agency consider and review policies, rather than approve them?"

Some believe the governance agency should consider and review policies and procedures dealing with all material aspects of the operation of a mutual fund and its distribution, while others believe it should only be concerned with policies around conflict issues. It was suggested to us that the governance agency should review policies and procedures on the following:

- All material compliance matters
- Sales communications and incentive plans
- Changes to portfolio management teams
- Fund mergers
- New fund launches
- Procurement and outsourcing services
- Manager performance review/compensation

- Ethics management
- ISO 9000 certification

We heard conflicting views on whether or not the governance agency should review policies on the use of derivatives.

c. Determine actions where non-compliance with policies and procedures or securities regulation

We were asked to provide further guidance on what would constitute a material non-compliance. The suggestion that the governance agency report non-compliance with policies to the regulator was not popular. Reporting to investors and asking the manager to remedy the non-compliance were presented to us as possible alternatives.

d. Approve benchmarks and monitor performance

Although it was agreed that investors are very interested in the performance of their funds, our suggestion that the governance agency consider and approve the fund manager's choice of benchmarks against which the fund performance is measured and monitor fund performance against these benchmarks was met with significant resistance. Lack of expertise, fear of micro-management, cost and duplication of efforts were the reasons cited. Several respondents suggested an alternative approach where the governance agency is only required to ensure the manager has a procedure in place for monitoring performance against benchmarks that are set out in the prospectus.

e. Monitor adherence to investment objectives

Our suggestion that the governance agency monitor adherence to investment objectives and strategies met with divided reaction. Those who opposed our suggestion argued that governance agencies do not have the expertise or experience to monitor investment objectives and will require the help of costly consultants. They suggested this is unnecessary given the fact that this is already monitored internally by investment management firms. A number of respondents posited that we could get to the same result by having the governance agency receive and review reports prepared by the manager on its adherence to the funds' investment objectives.

f. Establish a charter

A number of mutual fund managers warned that a governance agency should not be able to establish its own charter without the input of the manager or regulatory guidance because there would be little to prevent members from increasing their number and expanding their mandate. We were also told this approach would lead to a wide disparity among the mandates of various governance agencies.

g. Act as the audit committee

We received mixed reaction to our proposal that the independent members of the governance agency act as the audit committee for the mutual funds. Some respondents (including two existing governance agencies) believe the members of the governance agency could be effective in their audit committee role if they are qualified and properly prepared. Other respondents believe a traditional audit function is inappropriate for a governance agency. One letter pointed

out that the financial statements for mutual funds are transparent and the numeric/quantitative disclosure that must be set out is already prescribed.

We heard divergent views on whether or not the governance agency should review and approve financial statements. The majority of respondents agreed that governance agency members should be able to receive and review (but not approve) financial statements to the extent such review is necessary for them to fulfill their role and responsibilities. We were told that governance agency members should be entitled (but not required) to communicate directly with internal and external auditors of the funds to the extent such communication is necessary to fulfill their role and responsibilities. All of the respondents agreed that the governance agency should approve changes to auditors as the representative of investors, as investor votes in this area are costly and ineffective.

h. Approve related-party transactions

The large majority of respondents supported the idea that the governance agency would approve policies on related-party transactions and monitor compliance with those policies. In fact, a number of them asked us to make it clear that this is the major purpose of the governance agency. One asked us to clarify the extent to which the regulator still intends to be involved in the area of related-party transactions once the prohibitions are loosened in favour of governance agency oversight. A few smaller fund managers asked us to recognize that they do not engage in related-party transactions. We were reminded that for exchange-traded funds and index funds, there would be no value added by requiring a governance agency to oversee portfolio transactions due to the lack of investment discretion.

i. Evaluate the manager's performance

One letter contained the suggestion that the governance agency should also be responsible for evaluating the performance of the manager in various categories.

j. Monitor compliance with a compliance plan

The governance agency should also be responsible for monitoring the manager's compliance with the mutual fund's compliance plan, according to one respondent.

k. Oversee investment management

A letter from an accounting firm suggested the governance agency should also monitor fund performance, ensure that published investment performance information is accurate and timely, and receive periodic reports on the manager's business.

l. Review services provided and fees charged by the fund manager

An existing governance agency recommended that the governance agency be asked to review whether the unitholders are receiving adequate value for the management fees paid. A smaller mutual fund manager told us we should allow market forces to take care of this.

m. Review disclosure documents

There are those that believe the governance agency should review and approve mutual fund disclosure documents because this function is tied to its investor advocacy role. Others believe

mutual fund disclosure does not need to be approved by the governance agency but even they believe the governance agency can add value by reviewing and commenting on them.

CSA Response

The narrowed role for the governance agency brings with it a reduction in the number of responsibilities the governance agency will be required to carry out. For now, we will not ask the governance agency to do anything more than oversee conflicts of interest, including certain changes which currently require an investor vote in NI 81-102 (referred to as fundamental changes) we consider more akin to "business conflicts". As we explain in the Notice, this involves more than just approving related-party transactions. The governance agency will be required to set a mandate for itself after considering the kinds of conflicts that typically affect the fund manager.

Although we have narrowed the role of the governance agency, we strongly encourage the fund manager and the governance agency to consider whether the governance agency could have a broader mandate.

Governance principle 6. Standard of care for members

Public comment

Although the proposed standard of care for governance agency members attracted much comment, very few were opposed to the standard of care as a matter of principle. Instead, the comments were motivated by cost concerns (high salaries, costly insurance and the need for expert opinion), fears of micro-management or an overly cautious approach, and the feeling that potential members might be deterred from acting.

We were informed that insurance may not be available for governance agency members at a reasonable cost because insurance companies cannot accommodate exposure to unlimited liability. Two possible solutions to this problem were presented:

1. A cap on potential liability of governance agency members. A group of respondents agreed $1 million is an appropriate cap because that is the general statutory limit of liability for any breach of securities act provisions. A smaller group of respondents argued against such a cap because a cap on liability is not in the public interest and because governance agency members should have no more protection from liability than a board of directors. Others argued that the absence of such a limit in the corporate context is not adequate justification for not imposing such a limit here because the responsibilities of agency members will be very different from those of corporate directors.

2. A legislated business judgement rule. A significant number of respondents asked us to ensure that the defences available to corporate boards are also available to governance agencies so potential members can properly assess their personal exposure.

CSA response

We do not believe potential governance agency members will be deterred from acting due to liability concerns if their roles and responsibilities are spelled out clearly. Likewise, we believe the concerns around micro-management and an overly cautious approach disappear once the roles and responsibilities are narrowed and clarified. We do, however, appreciate the concerns around obtaining insurance at a reasonable cost. We are monitoring the draft uniform securities legislation which may give us the regulatory authority to limit the liability of governance agency members that may arise at common law.

Governance principle 7. Appointment of members

Public comments

Although some respondents cited the theoretical problems with the fund manager appointing the first members of the governance agency, this approach was generally thought to be the most practical one. Investor meetings are costly and ineffective, according to the letters, and fund managers, who owe a fiduciary duty to investors, are in a better position than investors to choose governance agency members. A number of respondents argued that appointments by the manager need not have a negative impact on the governance agency, provided the members are qualified, subject to legal liability, and a majority of them meet the definition of independent.

Our suggestion that the remaining governance agency members fill any vacancies received mixed reaction. A minority of respondents agreed the governance agency members can and should fill any vacancies. The majority of respondents would prefer the fund manager to be involved in the process. They argued that the existing members should simply ratify the manager's appointment of the new members because the manager is in the best position to identify qualified candidates, and this is consistent with corporate practice.

Some respondents voiced the opinion that the regulator need not develop guidelines on the qualifications of governance agency members while others told us this is important for us to do.

Our question "should investors who do not like the elected/appointed governance agency members be allowed to exit without penalty?" was met with an overwhelmingly negative response. According to commenters, excusing investors from paying deferred sales charges for this reason would defeat the contract between fund manager and investor and would leave it open to opportunistic investors to disrupt the manager's financing arrangements.

CSA response

We maintain our position that the fund manager should appoint the first members of the governance agency and that the remaining members should fill any vacancies thereafter with the assistance of the fund manager as necessary. Members of the governance agency will be appointed for specified terms.

We do not intend to develop guidelines on the qualifications of governance agency members. We believe this is something that can be left to industry best practices.

We agree that investors who do not like the governance agency should not be allowed to exit the fund and have their deferred sales charges waived. We think it highly unlikely that an investor would leave a fund solely because they do not like a given governance agency member.

Governance principle 8. Compensation of members

Public comments

The governance agency should not set its own compensation, we were told. In the absence of constraints, governance agency members will set very high salaries for themselves. All of the respondents agreed that the problems would be eased if the manager were involved in setting compensation. Some would have compensation set by the governance agency, or a committee thereof, and approved by the manager while others would give the manager sole responsibility for this job. The latter group argued that the manager is well equipped to set compensation and has an incentive to keep costs down so as not to detract from fund performance and fees generated. This is consistent with corporate practice. Our proposal to give the fund manager the ability to call an investor meeting if it considers the compensation to be unreasonable had both supporters and detractors.

The suggestion that we set regulatory limits on compensation was generally unpopular, though not uniformly so. We were asked not to prescribe dollar value limits on compensation because it is difficult to do with any precision and because market forces will quickly set appropriate benchmarks.

We were asked to clarify that governance agency members must be paid exclusively out of fund assets. Do not provide any flexibility for the fund manager to pay, the letters implored. It was suggested that if fund managers were to pay salaries, the independence of governance agency members would be lost.

CSA response

The governance agency will set its own compensation based on the fund manager's recommendation. The level of compensation must be fair and reasonable in the circumstances. We agree the governance agency should be paid exclusively out of fund assets.

Governance principle 9. Dispute resolution

Public comments

Respondents generally disliked the fact that our approach to dispute resolution turned on investor meetings. While one respondent agreed with the merit of giving the governance agency the right to call investor meetings, the remaining respondents went to great lengths to convince us that such meetings are inappropriate mechanisms for resolving disputes. Not only are they costly and labour intensive, they are poorly attended. We were warned that complicated issues could arise when different funds in the same family, or different classes of units within the same fund, vote differently on matters such as the election of agency members or a change of fund manager resulting from a change of control.

The vast majority of respondents strongly supported our decision not to give the governance agency the power to terminate the manager on its own, though one investor advocate did imply this was a mistake. The response to our suggestion that the governance agency be given the ability to ask investors to terminate the manager was mixed, but generally unfavourable. The investor chooses a fund manager just as much as he or she chooses a fund, we were told, and firing the manager would leave funds without management and result in the removal of the back office systems. Many said that the right to redeem is the only appropriate mechanism for terminating the fund manager.

Our proposal for informing investors of any unresolved disputes between the governance agency and fund manager was problematic for some. One letter noted that other reporting issuers are not required to file a press release describing a dispute and amend the prospectus in the event of an unresolved dispute and the writer queried why the CSA would impose more onerous disclosure rules on the mutual fund industry.

Several alternative approaches to dispute resolution were suggested, including recourse to the regulators, arbitration, disclosure, and the ability of governance agency members to resign en masse.

Our proposal to give fund managers the option of calling an investor meeting to have them terminate the appointment of governance agency members and elect new members made sense to some respondents, in theory. However, many respondents recognized that it is as impractical to ask investors to replace the members of the governance agency as it is to hold investor elections for governance agency members in the first place. One popular alternative was to empower the governance agency to deal with non-performing individuals, without a special meeting. Some respondents suggested that performance assessments of the governance agency and its members and limited terms for governance agency members would assist with this issue.

CSA Response

The narrowed role for the governance agency changes the nature of the relationship between it and the fund manager so that it is not overseeing the manager's actions as contemplated in the Concept Proposal. Under the proposed regime, where there is a conflict of interest, the fund manager must refer the matter to the governance agency and obtain its recommendation. The manager would be allowed to proceed even where the governance agency does not agree, but must disclose the governance agency's position and the reason for not following its recommendations to the fund's unitholders. The manager ultimately makes the decision to act and is liable for its decisions. Given the shift in the relationship, we believe dispute resolution is not as prominent an issue as it once was.

We will not mandate any particular dispute resolution mechanism but will leave it to each governance agency and fund manager to take the most appropriate course of action for the particular circumstances. We will require disclosure when the manager decides not to follow the recommendations of the governance agency. We believe, more than ever, that the governance agency should not have the power to terminate the management contract.

Governance principle 10. Reporting to investors

Public comments

Only one respondent explicitly agreed with our statement that the concept of reporting to investors is important. The remainder tended to disagree with our assertion that investors need to be connected to their governance agencies. You cannot force people to get involved, they told us. The reality is that most people don't read the prospectus. Mandating additional disclosure will not help investors take more of an active interest in their investments. Some respondents doubt that the governance agency's assessment of its own performance in the annual report will add value because it is doubtful that they will be able to make an objective assessment on this matter. The costs associated with giving notice to investors was thought to heavily outweigh any potential benefit.

CSA response

Although we continue to believe it is important to inform investors about the governance agencies for their funds, we have significantly reduced the amount of disclosure that will be necessary. We will allow any governance matters to be wrapped in with other periodic (continuous disclosure) reports that must go out to investors.

Recruitment and training issues

Public comments

At various points in the Concept Proposal, we queried whether our proposals would make it difficult to recruit qualified people to serve on governance agencies. A handful of respondents with governance experience informed us there is a sufficient pool of qualified individuals in Canada. One respondent went on to say that fund managers should have no trouble filling the seats on their governance agencies, so long as they are willing to look beyond the traditional pool of talent. Nearly twenty respondents, none of whom have prior experience in this area, voiced the concern that it would be difficult to recruit qualified, independent members at a reasonable cost. These respondents warned that there is a limited talent pool and that qualified people will not be willing to serve because of fears around personal liability. Some respondents felt they could not comment on this issue without more information on the roles and responsibilities and liabilities of a governance agency.

One respondent suggested we increase the pool of candidates by specifying that there is no prohibition against members sitting on governance agencies of multiple fund complexes. Another respondent raised concerns about confidentiality if members are permitted to sit on governance agencies of multiple fund families. The letter went on to suggest that confidentiality agreements be executed in those circumstances. Yet another respondent suggested that the manager should have the right to restrict agency members from sitting on the governance agencies of other funds.

Although everyone agreed that training is important, almost every respondent felt this was not something that should be mandated by the regulator. We were told the CSA should not mandate examinations or courses as prerequisites to sitting on a governance agency. Instead, the

respondents would leave it to each mutual fund manager to address. Some felt that the industry trade association should provide training.

The letters informed us that the training requirements could be very extensive—it could include training on all aspects of the mutual fund business and operations as well as training on the regulatory environment and fund accounting. We were warned that this could be a lengthy, costly and, perhaps, impossible task.

CSA Response

We believe it will not be difficult to recruit qualified people to serve on governance agencies at a reasonable cost. Governance agency members are not required to have any specialized knowledge and will not be called upon to exercise any specialized skills. Instead, they are there to exercise their judgement in conflict of interest situations. Recruiters can easily look beyond the traditional talent pool. The narrowing of the governance agency's roles and responsibilities directly impacts on the liability issue and this should temper the concerns of many respondents.

It is not our intention to mandate examinations or courses as prerequisites to sitting on a governance agency. This is an issue that is best left to the industry and each individual fund manager to work out.

Transition period

Public comments

The importance of an adequate transition period as we move to mandatory fund governance was underscored in the comment letters. We were told fund managers would need between 4 months and 5 years following the enactment of the rule to have fully functioning governance agencies. Most said two or three years would be ideal. One or two respondents urged us to bring the regulation into force as quickly as possible. A few small managers told us that implementation should be staggered according to size, with larger firms being required to establish their governance agencies first.

CSA response

We agree that an adequate transition period is essential. We have addressed this issue in the Proposed Rule.

General thoughts on fund governance

Public comments

The answer to our question, "will the governance agency have real power and real teeth?" was a resounding yes. In fact, some respondents fear the proposal will give the governance agency too much power. One respondent asked whether it makes sense to grant the governance agency such sweeping powers since the evils this regime is intended to address are not widespread.

The question, "will the governance agency add value for investors?" received a more varied response. At the positive end of the spectrum we had some letters that clearly recognized the

value of a governance agency designed to function as a proxy for investors in conflict of interest situations. The respondents in the middle were not convinced of the tangible value that fund governance will bring to investors but they appreciated the optics of independent oversight. At the other end of the spectrum were those respondents who believe fund governance will not add value for investors. These respondents tended to focus on the costs of the proposed regime.[4]

II. Registration of fund managers

The necessity of a registration regime for managers

Public comments

The comments were evenly divided between those who believe mutual fund managers should be registered so that they may be held to minimum standards and those who believe registration is not necessary. Those opposed to manager registration told us it is not warranted because fund managers are "market participants" who are subject to the oversight of most regulators and are already subject to a standard of care.

CSA response

We believe that minimum standards for mutual fund managers are an important part of a complete regulatory approach to mutual funds and their managers. At the same time, we recognize that a poorly designed system of registration is worse than no registration system at all. A number of policy initiatives with a registration component are currently underway. These include the USA project, the OSC Fair Dealing Model, the BCSC Model, and the CSA's Registration Passport System. We see the value in delaying our work in this area until these other initiatives have evolved further.

Because we do not propose a registration regime for mutual fund managers in the Proposed Rule, we do not respond to the comments on this pillar in the remainder of this paper.

Exemptions from registration

Public comments

The banks argued that bank-owned mutual fund managers should be exempted from any registration requirements because certain regulatory bodies, such as OSFI and the stock exchanges, already impose compliance rules on them and also because other entities within the mutual fund group are regulated through equivalent regulatory frameworks.

It was suggested to us that fund managers already registered as investment counsel/portfolio managers should be exempt from future fund manager registration requirements because adding another layer of registration would be duplicative.

[4] See the comments on the cost benefit analysis.

Condition of registration 1. Senior management positions

Public comments

Our proposal that each mutual fund manager be required to have a chief executive officer, a chief financial officer, a senior administrative officer and a senior compliance officer met with some resistance. We were informed that this will create a barrier to entry for smaller fund groups because they may find it difficult to justify filling four full-time senior management positions. A number of respondents told us that we should permit one person to fill multiple roles, like the IDA and MFDA do, or even allow for part-time positions.

Condition of registration 2. Criminal record checks

Public comments

The one letter that spoke to this point agreed that police and disciplinary checks should be conducted on senior officers and directors of the fund manager by the principal regulator.

Condition of registration 3. Minimum proficiency

Public comments

We received moderate support for our proposal that each of the senior officers and directors of the fund manager should be required to have at least three years of direct experience working in, or providing service to, the investment fund/securities industry. Some respondents asked, however, why we would require a higher standard of proficiency for fund managers than we do for companies registered as advisers or SRO members. A minimum level of experience should not be required, we were told, because it could be difficult to obtain in practice. Instead, we were asked to recognize that various types of experience may be appropriate and even valuable.

Our suggestion that the chief financial officer must have suitable financial and accounting training, as well as the expertise to enable such officer to fulfil the functions of such office, was uncontroversial. One mutual fund manager wrote that a CFA designation should be required of the person ultimately responsible for investment decisions.

In the Concept Proposal, we stated that senior officers would successfully complete: the Partners', Directors' and Senior Officers' Qualifying Examination (Canadian Securities Institute), the Officers', Partners' and Directors' Course (IFIC) or an acceptable equivalent. Some respondents agreed this would be appropriate while others did not believe that individuals should be required to pass any of the existing partners, directors, and officers exams since none of them relate specifically to the matters with which mutual fund managers must concern themselves.

The bulk of respondents do not believe the governance agency should be given the responsibility of determining the suitability of officers and their relative proficiency. They said that this is a role that is best left with the regulators who already have experience in this area and have access to records on many registrants.

Condition of registration 4. Filing the manager's financial statements

Public comments

It was agreed that mutual fund managers should file their annual audited financial statements with the principal regulator.

Condition of registration 5. Minimum capital

Public comments

Of all of our proposals under this pillar, the proposal to impose a minimum capital requirement was the most controversial. Ten respondents, including four banks, told us a minimum capital requirement is justified. Twice that number did not accept the reasons we offered for a minimum capital requirement. Critics told us that minimum regulatory capital is a concept borrowed from the regulation of financial institutions where protection of deposits is a primary concern. In contrast, mutual fund assets are lodged with a third party custodian, so minimum regulatory capital is not needed to ensure an investor is able to get his or her redemption proceeds if the manager becomes financially troubled. We were reminded that capital requirements have been rejected in other international jurisdictions, such as the United States.

Respondents told us that a capital requirement will increase the cost of doing business for fund managers. We were warned that minimum capital will act as a barrier to entry into the industry for smaller, niche mutual fund managers and that it will force the closing or consolidation of smaller firms. We were also informed that a capital requirement will amount to a form of indirect taxation on large firms that will effectively punish them for each substantial new mandate they win.

Each of the formulae for calculating minimum capital we presented were criticized as being inappropriate. Many respondents felt the levels of capital recommended were excessive and they asked us to justify why we proposed capital requirements significantly in excess of the current requirements for ICPM's and mutual fund dealers. We received a number of thoughtful letters explaining why it is inappropriate to calculate minimum capital on the basis of assets under management. These letters explained that a larger manager is not necessarily riskier than a small one. In fact, the probability of the fund manager collapsing and not meeting its liabilities decreases as assets increase. We were also informed that a minimum capital requirement that is fixed as a percentage of assets under management would create difficulty for managers experiencing rapid growth in assets under management in a short period of time. Respondents stated a preference for a flexible risk-based calculation over one that is tied to assets under management. Some suggested we adopt the current adviser capital requirements in Ontario.

A number of comment letters contained the recommendation that we look to private insurance or a contingency fund rather than a regulatory capital requirement.

Condition of registration 6. Insurance

Public comments

One respondent agreed that fund managers should have minimum insurance coverage, provided it is readily available at reasonable rates. Other industry participants suggested that insurance is not necessary, so long as the manager is independent of the custodian. One mutual fund manager posited it may be more sensible to "self insure" some risks, depending on their nature and the terms and costs of available coverage. These are decisions that are best left with the fund manager, we were told, they should not be second-guessed by a regulator.

Condition of registration 7. Implementation of internal controls, systems, and procedures

Public comments

The respondents to this part of our proposals tended to think internal control procedures should not be regulated. "Good business practice and prudence would dictate that fund managers address these matters," one fund manager told us. "We are concerned that once this process becomes bureaucratized, it will become "one size fits all", so that all fund companies, regardless of their size, business mix or complexity, will be forced into one mold." It was also called to our attention that these functions are often carried out by the trustee rather than the fund manager. If this is the case, it may not be appropriate to impose these obligations on the fund manager.

We received various comments about the appropriate components of the list of internal controls.

We heard from a number of respondents that auditors should not be given the burden of reviewing internal controls. This was thought to be costly and duplicative.

Condition of registration 8. Controls for monitoring service providers

Public comments

It was taken as a given that a fund manager would have adequate resources, systems and procedures and personnel in place to monitor the services provided by third parties but respondents would prefer that this not be mandated.

Some felt it would not be unreasonable to require third-party service providers to have Section 5900 engagements conducted. One respondent recommended that Section 5900 reports be received by auditors who present them to the governance agency or its audit committee. Others told us it would not be appropriate to require third party providers to obtain a Section 5900 report from an accounting firm as a condition of providing services to a manager or a fund due to their expense. A number of smaller mutual fund managers doubted that they could insist on a detailed review by their auditors or a Section 5900 report. To insist on such an audit by third parties may reduce selection of available suppliers, they told us.

General thoughts on manager registration

Public comments

Industry participants impressed upon us the importance of a well-designed registration system. A poorly designed system that lacks the flexibility to permit different business models will be a barrier to entry, we were warned. We were asked to make the system as streamlined as possible with an annual registration process in one Canadian jurisdiction to govern registrants who desire to conduct business across Canada.

III. Product regulation

Replacing conflict of interest prohibitions with governance agency oversight

Public comments

We stated our intention in the Concept Proposal to replace the related-party prohibitions with governance agency oversight.[5] With the exception of two smaller fund managers, the respondents supported the proposed relaxation of any rules that become redundant or unnecessary due to the introduction of fund governance. Some respondents would go even further and have us eliminate the restrictions on related-party transactions as soon as possible, regardless of whether or not fund governance is introduced. One law firm asked us to conduct an empirical study of the current related-party rules, to identify issues, abuses (if any), and to assess the negative impact (if any) of such rules on public mutual funds in Canada. The related-party rules should not be liberalized without such empirical work first being conducted, they explained.

CSA response

We believe that the existing related-party prohibitions may be replaced with governance agency oversight. The Notice to the Proposed Rule outlines which prohibitions will be affected and explains exactly how the new approach to related-party transactions will operate.

Streamlining the investment restrictions and practices

Public comments

Our proposed plan to streamline the investment restrictions and practices was generally well liked. Some respondents would have us immediately address all of the provisions from which we routinely grant exemptive relief, such as the fund-on-fund restrictions. We were told that the 10% concentration restrictions and restrictions concerning illiquid assets should be simplified or eliminated altogether. Some respondents supported the idea of replacing some of the investment restrictions, such as the securities lending and repurchase transaction rules, with governance

[5] See the comments above under Governance Principle 5(h).

agency oversight. At the same time, we were told that certain aspects of regulation are most appropriately addressed through prescriptive restrictions and not all such regulation can be replaced through guidelines or governance agency oversight. Respondents said that the Concept Proposal does not provide enough detail on the proposed changes to the product regulation.

CSA response

Given the level of oversight that would have been provided by the governance agency contemplated in the Concept Proposal, we proposed to relax much of the product regulation in NI 81-102. However, in response to public comment, the regime being proposed now is much narrower than what we described in the Concept Proposal.

A number of respondents asked us to focus the attention of the governance agency on areas where it could add value, with everyone agreeing that the governance agency should concentrate on approving related-party transactions. Accordingly, we have focussed our changes to the product regulation regime on conflicts of interest.

We believe the proposed regime offers us a flexible platform for future regulatory reform. As we said in the Concept Proposal, we believe it is important to consider a renewed framework for regulating mutual funds and their managers. Consultations with industry are continuing with a view to publishing a revised product regulation system for comment.

IV. Investor rights

Fundamental changes

Public comments

Our decision to re-examine whether investor meetings need to be called when certain changes (which are currently referred to as fundamental changes) are proposed met with strong support. We were told very clearly that investor meetings should be avoided at all costs because mutual fund investors are generally not interested in actively participating in the investment management of their holdings. Investor meetings are poorly attended and investors generally accept the status quo or redeem their units. To make matters worse, these meetings are expensive to organize and they are a complex administrative exercise. That being said, it was suggested investors should retain the right to approve changes where a new, non-related mutual fund company assumes the contract to manage the mutual funds and where there is a change in investment objectives.

We were strongly encouraged to use the governance agency as a "proxy" for investors when it comes to approving fundamental changes. Most of the respondents on this point agreed this would significantly reduce costs. The decision to change auditors, in particular, was widely thought to be one the governance agency should make.

Our suggestion that we would consider whether minority rights should be provided to investors who do not agree with a fundamental change to their mutual fund was met with strong

opposition. The reasons given were identical to those we received in response to our suggestion that investors who do not like their governance agency be allowed to exit their funds without paying deferred sales charges.

CSA response

Under the proposed regime, certain changes which currently require an investor vote under NI 81-102 (referred to as fundamental changes) will be referable to the governance agency. We recognize, however, the perception that some of the changes currently requiring investor meetings, such as changes to the mutual fund's fees or its investment objectives, are viewed by many investors as changes to the essence of the 'commercial bargain' between investors and the mutual fund. We are not proposing to replace investor meetings with governance agency oversight in those circumstances.

V. Enhanced regulatory presence

Although we did not set out any specific proposals under this pillar, we did pose the question, How can we better carry out our role as regulator? We received the following comments in response:

Create a national regulator or increase harmonization

Public comments

We received some comments on the need to create a national or pan-Canadian regulator. A harmonized Securities Act and mutual fund rules were also a top priority for the industry. The IFIC letter warned that the industry does not support any proposal that is not implemented and adopted in a standardized and uniform manner across Canada. Other letters called for the co-ordination of the many projects and proposals that are ongoing.

CSA response

Mutual Fund rules are already largely harmonized across Canada. The CSA project to create uniform securities legislation (the USL project) will harmonize other areas affecting mutual funds across the country. The creation of a national regulator is outside the scope of this project.

Increase regulatory compliance reviews and crack down on violators

Public comments

Be more proactive and perform more audits, one letter urged. Respondents asked us to "develop teeth" and discipline malfeasants.

CSA response

The renewed framework for regulating mutual funds and their managers that we set out in the Concept Proposal would include an increased regulatory presence. Although this initiative falls outside the ambit of the Proposed Rule, some jurisdictions have begun developing a new protocol for reviewing prospectus and continuous disclosure documents filed by mutual funds, as well as beginning on-site inspections of fund managers and registered advisers.

Improve disclosure

Public comments

We were asked to reduce the contents of the prospectus and ensure these documents are available on the internet. One fund manager told us a standard two page point of sale document would be very beneficial to the investing public. It would improve general awareness and ensure that adequate disclosure is actually communicated and understood by investors.

CSA response

The Joint Forum of Financial Market Regulators has published a Consultation Paper that discusses its proposals to harmonize and improve the point of sale disclosure regimes for mutual funds and segregated funds. This paper includes proposals to deliver a one or two page disclosure document at the point of sale and to adopt an access-equals-delivery approach to disclosure documents that are posted online.

The cost-benefit analysis

Public comments

The cost analysis undertaken by our Chief Economist was the subject of much scrutiny and comment. The most important comment received was that the costs have not been clearly and accurately considered. Many believe the costs have been understated and they informed us that the analysis does not take into account the costs of:

- the additional regulatory burden
- the registration regime, including any capital requirements
- initial disruption to the manager when setting up a governance agency
- insurance for the unlimited liability of members in the current, unfavourable insurance market
- educating members
- transportation to and from meetings

- remuneration of governance agency members given their extensive responsibilities and unlimited liability
- preparing and running meetings, including dedicated administrative staff
- increased time demands on management and staff
- internal reports
- implementing recommendations by the governance agency
- dealing with litigation (frivolous and not)
- increased use of external consultants due to liability concerns
- reporting requirements to investors including preparation, translation, printing and mailing these materials

Some respondents felt it was misleading to express the costs in terms of total assets under management because it obscures the fact that small firms will pay significantly more of the cost, as a proportion of assets under management, than large firms. Also, when assets under management decline during market downturns, the costs will rise as a percent of assets under management, we were told.

The vast majority of respondents informed us the costs of our proposals may not, or will not, outweigh the benefits. We were told the industry is less resilient than it once was and is, as a result, less able to absorb new costs. We were also told that investors, who will ultimately bear the costs of our proposals, may not be willing to pay. The fear is that an overly costly regime could make mutual funds less attractive to the people who benefit from investing in them.

A number of smaller mutual fund managers strongly disagreed with the conclusion that .178% of assets under management for small managers is not an insurmountable obstacle. They tell us that even if the 16 bps estimate is accurate, it may undermine the viability of small mutual fund managers. Smaller fund managers informed us they would be forced to: (i) pass on some or all of the additional costs to the funds which would put their funds at a disadvantage; or (ii) incur the expenses themselves, which could have a significant adverse impact on their operations. One manager told us they would consider winding down their mutual funds if fund governance is mandated.

A number of respondents also noted how difficult it is to assess our proposals without a full analysis of the benefits of the five-pillared approach to mutual fund regulation. While some were optimistic that a significant benefit will accrue if the governance agency is empowered to deal with conflicts of interest, one smaller manager noted that the benefits would mostly accrue to large, not small, players.

CSA response

The cost-benefit analysis will be revised. The Notice to the Proposed Rule provides a summary of the proposed methodology for the cost-benefit analysis. This paper and the analysis by an independent consultant of the benefits of relaxing the existing related-party prohibitions are available in their entirety on the website of the Ontario Securities Commission at www.osc.gov.on.ca and the Commission des valeurs mobilières du Québec at www.cvmq.com.

Alternatives to our proposals: Public Comments

The Concept Proposal outlined the alternatives we considered in developing the approach we described in that document. It also set out the pros and cons to each alternative. Given our proposal to focus fund governance on all conflicts situations and our belief in the need for consistent industry-wide standards, we have not adopted any of these alternatives. Because of this, we do not respond to the comments on this subject in the remainder of the paper.

Voluntary governance

Public comments

We were asked to consider a voluntary approach to governance coupled with best practice guidelines and disclosure. Proponents of this approach believe governance need not be mandated yet because they believe the industry is already moving towards voluntary governance. They point out that this is a more cost-effective approach that will allow each manager to decide what is best for it. Critics of the voluntary approach tell us it lacks teeth and will result in an uneven playing field for fund managers and confusion for investors. The assumption that investors read and understand the prospectus was questioned by some.

Governance in lieu of registration

Public comments

It was argued that both fund governance and manager registration have their merits and should be mandated. Registration is needed, said one respondent, to protect the integrity of the industry and investor confidence.

Enhanced duties for auditors or the regulator

Public comments

There were those who believe investors and the industry would be better served by increased audits or regulatory oversight than by fund governance because auditors and the regulator have the requisite knowledge and sophistication to address conflicts of interest. However, some respondents did not share their faith in auditors or the regulators: “One only has to look to the Enron debacle to see how ineffective auditors can be. As for regulators, there are serious time/money constraints and cost/benefit issues with enhanced regulation.” We were told that auditors are not well positioned to address conflicts of interest.

An incremental approach to change

Public comments

We were advised to take an incremental approach to change rather than making sweeping changes. Respondents believe this is a safer and more cost-effective approach.

A two-tiered approach to governance

Public comments

Some respondents asked us to consider a voluntary approach to governance which ties the benefits of a simplified regulatory framework (relief from the prescriptive rules) to the adoption of governance. This approach would give small fund managers the option of abiding by the existing prescriptive regime or adopting a fund governance agency if it is viable from a cost perspective for them to do so.

Shared governance agencies

Public comments

It was suggested that smaller mutual fund companies could effectively "co-op" the independent governance agency function, such that a group of independent individuals could serve as the independent membership component for the governance agencies for various fund groups.

A governance agency with fewer independent members

Public comments

We were asked to relieve smaller fund managers from the requirement for majority independent membership. Under this proposal, a fund group with less than $500 million in assets under management would be permitted to have a governance agency with only one independent member. The governance agency could not take, or refrain from taking, any action that was inconsistent with the views of the independent governance agency member. We also heard the

suggestion that we allow small managers to use a pre-existing internal governance structure even if it is not independent.

An enhanced role for the trustee

Public comments

According to the letters, another alternative is to expand the role of the Trustee so that it reviews conflicts of interest.

Manager registration instead of governance

Public comments

One respondent suggested that registration can accomplish much of what we seek to do with governance. This respondent went on to recommend that mutual fund managers that are subsidiaries of a financial group or those mutual fund managers that meet a minimum capital requirement should be exempt from the requirement to have a governance agency, provided they are registered.

Enhanced disclosure instead of governance

Public comments

Some respondents asked whether some or all of the objectives of the Concept Proposal could not be achieved through improved disclosure.

Deregulation without governance or registration

Public comments

A number of respondents suggested a reduction in prescriptive regulation may be appropriate even in the absence of fund governance. We were asked to look at whether there are aspects of the current regulatory regime which are simply unnecessary across the industry or in respect of certain industry sectors.

Require managers to register as IC/PM

Public comments

One respondent asked, instead of creating a whole new category of registrant, why not require fund managers to be registered as Investment Counsel/Portfolio Manager? This is a reasonable standard and it would be extremely simple to implement, they argued.

An SRO instead of manager registration

Public comments

We were asked to consider the industry oversight, or SRO, model instead of manager registration. Some respondents suggested that mutual fund managers have the necessary experience to exercise competent oversight over the process of manager registration. Other respondents, however, told us they do not support having another SRO-type association regulate the mutual fund industry.

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

Our proposal to regulate like products in a like manner was generally well received. Many respondents stressed how important it is to create a level playing field. Some industry participants feel the mutual fund industry in Canada is heavily regulated compared to other industries and they tell us this is unjustified. They fear that other investment vehicles may gain an even greater competitive advantage if they are not subject to the costs of fund governance.

A small group of respondents took the position that fund governance should be mandatory for all investment products. According to them, a governance agency should be required whenever there is the potential for investor abuse brought on by conflicts of interest. A slightly larger group took the position that fund governance should only be required for those funds that are sold to less sophisticated, retail investors. We were advised to leave the exempt market alone.

We believe our proposals do not create different regulatory schemes for substantially similar investment products. Since we do not propose to regulate all investment funds in the Proposed Rule, we do not respond to the comments on this subject in the remainder of the paper. As we said in the Concept Proposal, as we move forward with our renewed framework for the regulation of mutual funds, we will be working towards meeting the challenge of determining which aspects of mutual fund regulation, if any, should also be applied to other investment vehicles.

Labour Sponsored Investment Funds

Public comments

The majority of respondents told us the regulation of LSIFs should be harmonized with the regulation of mutual funds, with modifications as necessary. One respondent strongly disagreed with this position. This respondent argued that LSIFs should not be subject to the regime contemplated by the Concept Proposal because most of it is inapplicable to LSIFs. We were informed that LSIFs already have highly evolved governance structures. As corporations, LSIFs are governed by boards of directors with the fiduciary duties outlined in their governing corporate statute. This respondent went to explain that LSIF boards would be unduly restricted if they were bound by the governance principles.

Commodity pools

Public comments

While some respondents felt the regulation of commodity pools should be harmonized with the regulation of mutual funds, others asked us to assess the regulation of commodity pools apart from this proposal. It is a subject for subsequent consideration, we were told.

Segregated funds

Public comments

A handful of respondents felt the regulation of segregated funds should be harmonized with the regulation of mutual funds. In contrast, some respondents, including the trade association for the insurance industry, argued the proposed framework should not be extended to individual variable insurance contracts related to segregated funds. One letter pointed out that the risks presented by segregated funds and mutual funds are quite different and these differences argue for a different approach to regulation. The trade association informed us that segregated funds are already subject to a governance regime that bears striking resemblance to the proposed regime.

Pooled funds

Public comments

Although a handful of respondents told us the regulation of pooled funds should be harmonized with the regulation of mutual funds, the vast majority of respondents told us it is inappropriate to expand our proposals to pooled funds. The major argument against this is that sophisticated pooled fund investors do not need the same protections as mutual fund investors. Investors in a pooled fund do not need a governance agency to oversee the management of the fund as they themselves act as their own governing body through their close relationship with the manager. We were reminded that pooled funds are used to structure innovative portfolios in a cost-effective manner. Layering on mutual fund rules would compromise their ability to invest efficiently. We were also reminded that the current adviser registration accurately reflects the reality of the core business and does not impose an artificial "product" perspective upon the business.

Hedge funds

Public comments

The comments were evenly split as to whether or not the regulation of hedge funds should be harmonized with the regulation of mutual funds. One manager of hedge funds told us adding mutual fund regulation to this market will prohibit the availability of such strategies and will, therefore, serve to perpetuate market inefficiencies, forcing hedge fund managers to focus on markets and investors outside of Canada. Such an approach would also deprive Canadian institutional investors of the benefits that would otherwise be available to them by investing in hedge funds, they said.

Exchange Traded Funds

Public comments

Again, the comments were evenly split as to whether or not the regulation of ETFs should be harmonized with the regulation of mutual funds. One manager of ETFs warned the proposal could significantly impact the current cost structure of ETFs and undermine the value of the product as it is currently structured.

Quasi closed-end funds

Public comments

All of the respondents on this point told us the regulation of quasi closed-ended funds should be harmonized with the regulation of mutual funds.

Closed-end funds

Public comments

The majority of respondents agreed the regulation of closed end funds should be harmonized with the regulation of mutual funds. They told us governance is even more important with respect to publicly offered closed-end funds, as investors do not have the right to effectively "vote with their feet" by redeeming at net asset value. A manager of closed-end funds warned us that if we regulate private closed-end funds like mutual funds, we will be closing a small but very valuable aspect of the Canadian capital markets and narrowing investment options for investors.

Capital accumulation plans

Public comments

All of the respondents on this point agreed CAPs should not be subject to a fund governance regime because it would discourage employers from offering savings plans to employees, add to the fund management costs borne by plan members and decrease their ultimate return. We were informed that the Canadian Association of Pension Supervisory Authorities is working with the pension industry on extensive plan governance guidelines. Also, the Joint Forum of Financial Market Regulators is looking at this area and we were encouraged to await the outcome of the Joint Forum's work before introducing an entirely new area of regulation to this part of the industry.

Wrap accounts

Public comments

The only respondent on this point told us wrap accounts should be treated the same as mutual funds.

Appendix 1. List of respondents

Association of Canadian Pension Management
Acuity Funds Ltd.
AGF Management Limited
AIM Funds Management Inc.
Association for Investment Management and Research
Association of Labour Sponsored Investment Funds
Altamira Financial Services
Assante Asset Management Ltd.
Barclays Global Investors Canada
Borden Ladner Gervais LLP
BMO Investments Inc.
Certified General Accountants Association of Manitoba
Capital International Asset Management (Canada) Inc.
Canadian Imperial Bank of Commerce
Clarington Funds
Canadian Life and Health Insurance Association Inc.
Cundill Funds' Board of Governors
Cyril Fleming
Dynamic Mutual Funds Ltd.
Dynamic Mutual Funds' Board of Governors
Fasken Martineau Dumoulin LLP
Fidelity Investments
Fogler Rubinoff LLP for Friedberg Mercantile Group
Fonds des professionnels inc.
Frank Russell Canada Ltd.
Franklin Templeton Investments
Guardian Group of Funds
Howson Tattersall Investment Counsel Limited
HSBC Investments Funds Canada Inc.
Investment Counsel Association of Canada
Investment Company Institute
Investment Funds Institute of Canada
Investors Group
Jim Baillie at Schulich Investment Forum
Ken Kivenko
Lawrence Schwartz
Leith Wheeler Investment Counsel Ltd.
Lighthouse Private Client Corp.
Mawer Investment Mgt.
McCarthys
McLean Budden
MD Management Limited
Mulvihill Capital Management
National Bank
Northwater
Primerica Financial Services Investments Canada Ltd.
Phillips, Hager & North
PricewaterhouseCoopers
Robert Druzeta
Royal Bank of Canada Funds Inc.
Royal Mutual Funds' Board of Governors
Stikeman Elliott
Synergy Asset Management Inc.
TD Asset Management Inc.
Tradex Management Ltd.
Westcap Management Ltd.
Zenith Management and Research Corporation