New Proposals for Mutual Fund Regulation

November 14, 2002

A NEW WAY TO REGULATE

BRITISH COLUMBIA SECURITIES COMMISSION

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EXECUTIVE SUMMARY

These Proposals were developed from the concepts contained in our paper, *New Concepts for Securities Regulation*, published for comment in February 2002. The Proposals reflect the comments we received on the February paper and our further study. Other proposals arising from that paper were described in our paper, *New Proposals for Securities Regulation*, published in June 2002. The February and June papers are both available on our website at www.bcsc.bc.ca/bcproposals.

The following Proposals describe a complete regime of mutual fund regulation (with the exception of statutory civil liability – see below). Elements of them overlap with other initiatives that the Canadian Securities Administrators (CSA) are currently considering relating to mutual fund governance, fund of funds, and investment fund continuous disclosure. In addition, the Joint Forum of Financial Market Regulators, in which we participate, is working on various issues relating to fund distribution.

Our goal is not to develop a stand-alone regime for mutual fund regulation in British Columbia. We are putting these Proposals forward for discussion so that industry and other stakeholders can consider them in the context of all initiatives currently under way. The goal is to arrive at a national approach that incorporates the best ideas.

We are publishing these Proposals for comment and will be actively consulting with industry and investors, our fellow regulators, self-regulatory organizations (SROs), and other stakeholders to discuss the Proposals in detail. If you wish to comment on these Proposals or are willing to participate in focus group consultations, please contact us at our website.

We are not publishing proposals about a civil liability regime for mutual funds. We are considering civil liability for all our proposals, including mutual funds, in light of the comments we have received on our June proposals, the civil liability provisions recently introduced in the Ontario legislature, and our own further study.

I. Summary

Under these Proposals:

1. The current prospectus-based disclosure system for mutual funds would be replaced by a system based on continuous disclosure. Mutual funds would file an AIF and keep all significant information up to date in the market at all times. Mutual funds could sell to investors based on this record of continuous disclosure. A point of sale document would be permitted but not required.

2. Codes of conduct would be mandated for mutual fund companies, advisers and mutual fund dealers. These Codes would substitute general principles and guidance for detailed, complex and prescriptive rules governing business conduct and product regulation.

3. Foreign funds that do not solicit investors in Canada would be allowed to sell funds to Canadian investors without complying with Canadian requirements, as long as they act in accordance with applicable foreign requirements and make certain disclosures.

4. Non-public mutual funds could only sell their units to
   - Accredited investors (financial institutions, pension and investment funds, substantial corporations and wealthy individuals)
   - Employees and consultants of the fund company, its affiliates and advisers
   - Clients of an adviser who buy securities of in-house pooled funds of the adviser

II. Background

Our consultation process

Since releasing our February and June papers, we have held town hall and focus group consultation sessions with interested market participants in Vancouver, Calgary, Winnipeg, Toronto and Montreal. Hundreds of interested people have attended these sessions, representing all sectors of the industry, investors, SROs and other regulators.

We have also received dozens of written comments on our ideas and proposals.

It is clear that there is a thirst for a new look at securities regulation in Canada. Many of those who commented on our proposals welcomed the “fresh look at the existing securities regulatory regime” we are providing and praised the “bold approach” we have taken in our papers. In a national survey we conducted of public companies, 77% of the companies surveyed expressed support for the Continuous Market Access system, one of the proposals described in our June paper.

Through the consultation process we learned that there is strong support for a principles-based, rather than a rules-based, approach to regulation. There is also strong demand for uniformity of legislation and rules, and most feel that complexity must be addressed as much as possible in the course of developing uniform legislation.

Cost benefit analysis

It was our intent from the outset to test the costs and benefits associated with our ideas. This is currently under way. Our analysis of the Continuous Market Access system is complete (see our report, *Better Disclosure, Lower Costs*, on our website) and we are now beginning studies on some of our other major proposals.

The CSA Uniform Securities Law Project

The CSA Uniform Securities Law (USL) Project is creating a uniform securities act and set of rules for adoption throughout Canada.

The USL Project provides an opportunity to do two things that would substantially improve the efficiency and competitiveness of Canada’s securities markets. First, we can eliminate the differences among securities legislation in different provinces, and second, we can simplify and update a system of regulation that has grown too complex and has failed to keep pace with a rapidly changing market.

One of the main themes from the consultation process is the desire for uniformity. There is also strong support for reducing complexity. We are continuing discussions with our colleagues on the CSA USL Committee about the need to address the complexity issue as we develop uniform legislation and rules.

The market environment

Recent scandals in the United States involving corporate governance and financial reporting failures have shaken public confidence in securities markets. With these events in mind, some are skeptical of an approach to regulation that calls for a reduction in regulatory burden and the avoidance of prescriptive rules. More rules, not fewer, is what is needed, they say.

We have two responses to that. First, many regulators and market participants are far from sure that more rules are the answer.

The recent events have prompted many regulators, market participants and industry observers to re-examine the approach to regulation. Several leaders in regulation and industry have spoken publicly on this issue in recent months. Many of them have made observations that should give regulators and legislators pause before rushing to impose a raft of new prescriptive rules to “tighten up” the system.

Sir David Tweedie is Chairman of the International Accounting Standards Board. In a statement delivered to the United States Senate Banking Committee on February 14, 2002, he said the following:

> . . . business failures seldom have a single simple cause. They are usually much more complex than they first seem and the rush to a single answer is usually wrong.
> . . .
> The IASB has concluded that a body of detailed guidance (sometimes referred to as bright lines) encourages a rulebook mentality of “where does it say I can’t do this?” We take the view that this is counter-productive and helps those who are intent on finding ways around standards more than it helps those seeking to apply standards in a way that gives useful information. Put simply, adding the detailed guidance may obscure, rather than highlight, the underlying principle. The emphasis tends to be on compliance with the letter of the rule rather than on the spirit of the accounting standard.
> . . .
> We plan to develop standards based on clear principles, rather than rules that attempt to cover every eventuality.

Howard Davies is Chairman of the Financial Services Authority in the U.K. In a speech to the China Securities Regulatory Commission on April 22, 2002 on the subject of corporate governance, he said the following:

> People are more important than processes. . . . One lesson of recent corporate collapses in the US and in Europe seems to be that no corporate structure can guarantee success if the individuals within it do not operate with the right degree of independence, with the right kind of expertise, and do not devote the required amount of time to the important role of non-executive director.

At a recent meeting of leaders of Canadian financial regulators, industry organizations and public companies, the moderator (a person with a long and distinguished career in the securities industry) observed, “Absent individual integrity, the system will not function, regardless of command and control ‘solutions’. Where individual integrity fails, there must the axe fall; and not on swiftly and ill-considered legislated/regulated systemic reforms.”

We share the views of these observers. If anything, the events of the past few months confirm the need for an approach to regulation along the lines we described in our February paper:

1. Keep the right balance between regulatory restrictions and market freedom.
2. Make the rules as simple and clear as possible.
3. Foster a culture of compliance in industry.
4. Act decisively against misconduct.
5. Equip investors with effective self-protection tools.

Our second response to the call for more rules is that our proposals are all about making regulation more, not less, effective. We are proposing improved disclosure in many areas, a greater focus by industry on what is right for their clients and the market, and more accountability for all market participants. In the process, we are proposing to remove unnecessary regulatory clutter that imposes costs on industry but adds little in the way of investor protection.

CHAPTER 1
DISTRIBUTION OF MUTUAL FUNDS

1. Offering mutual funds to the public

This section describes our Proposals for public mutual funds. Separate regimes would apply to non-public and foreign-regulated funds. See “Restricted mutual funds” and “Foreign-regulated mutual funds” below.

Background

Currently, mutual funds that wish to distribute their securities to the public must file an annual information form (AIF) and simplified prospectus, which are vetted by Commission staff before the fund can be sold to the public. The simplified prospectus must be delivered to investors within two days of purchase and the AIF must be delivered to investors upon request.

In *New Concepts for Securities Regulation*, published in February 2002, we noted that past surveys of investors found they did not read mutual fund prospectuses and relied solely on their advisers when making investment decisions. Since those surveys were completed, National Instrument 81-101 *Mutual Fund Prospectus Disclosure* implemented a new disclosure system for mutual funds. This system was designed to encourage investors to read the documents and resulted in a simplified prospectus that was much easier to read and understand.

There is a high degree of consensus among industry and regulators that the current mutual fund prospectus system, although much improved over its predecessor, is not working. Prospectus documents under NI 81-101 are lengthy, cumbersome and largely unread by investors. They are also expensive to prepare and deliver.

In February we suggested that we should resurvey investors. However, based on our consultations and additional research, we believe the need to revamp the system is apparent and that a survey is not necessary.

We are not the only ones looking at this issue. The Joint Forum of Financial Market Regulators[1] is considering a variety of issues, including the disclosure that investors buying mutual funds or segregated funds should receive, with a view to harmonizing the two regimes. The Joint Forum will publish its proposal for comment in the next few months and we expect the spirit of that proposal will be consistent with this one. As Joint Forum participants, we will monitor and consider the comments on their proposal.

[1] This group was formed in 1999 by the Canadian Securities Administrators (CSA), the Canadian Council of Insurance Regulators and the Canadian Association of Pension Supervisory Authorities to facilitate and coordinate the development of harmonized cross-sectoral and cross-jurisdictional approaches to financial services regulation. The BCSC, through CSA, is a full participant in the Joint Forum.

Initial AIF

Under our Proposal, funds that are currently reporting issuers using the NI 81-101 disclosure system would automatically fall under the new regime.

A mutual fund wishing to issue securities to the public for the first time would prepare and file an initial AIF. The initial AIF would disclose all "significant information" (see "Continuous disclosure: The disclosure standard" below) about the mutual fund's business, operations and affairs, including information about its fund company (the entity responsible for all aspects of managing the mutual fund).

Regulators would vet the initial AIF. In most cases the review would be focused on identifying:

- Non-compliance with the Code of Conduct for Fund Companies (see Chapter 2)
- Unsuitable directors, officers or trustees of the mutual fund or fund company
- Significant non-compliance with the AIF disclosure requirements
- Management integrity or competence issues

If the fund company could not satisfy concerns raised by staff, the executive director could refuse to accept the mutual fund's initial AIF (subject to the fund's right to be heard).

Once the initial AIF was accepted, the fund would be subject to the continuous disclosure regime for mutual funds and all its significant information would be available to the market at all times. The mutual fund would disclose new significant information by filing a notice on SEDAR and sending the notice to the fund investors that have elected to receive fund information. (Under our Proposal, investors would not receive disclosure materials unless they request them; see "Delivery" below).

Point of sale disclosure

We propose that the current prospectus requirement be eliminated and no point of sale document be mandated.

If a fund company for a fund chooses to use a point of sale disclosure document, it would have to file it on SEDAR and the document would become part of the fund's continuous disclosure record. Regulators would not vet the document, other than as part of a continuous disclosure review.

We are proposing to permit, but not require, a point of sale document for two reasons.

First, in consultations we heard that a point of sale document is necessary in the mutual fund market. Investors want some sort of document that gives them basic information about their funds. Therefore, we do not need to mandate what the market already demands. Second, because the fund's continuous disclosure record would contain all significant information at all times, there would be no new significant information to disclose in the point of sale document. (In fact, all disclosure of significant information would be made in the AIF and significant information notices; the point of sale document would not be an acceptable place to disclose new significant information.) We therefore think that the content of any point of sale document should be governed by investor demand.

When preparing a point of sale document, a fund company would have to ensure that the disclosure is balanced. A fund company would have to disclose both the positive and negative aspects of any significant information included in the document. If a point of sale document contained a misrepresentation (see "Continuous disclosure: The disclosure standard" below), the fund company would be exposed to civil liability, administrative sanctions and criminal penalties.

We would place the educational information currently in the simplified prospectus in an investor education document that would be available electronically.

Delivery

Proposed National Instrument 81-106 *Investment Fund Continuous Disclosure* proposes a "delivery on request" system under which no document would have to be delivered to investors unless the investors made a general election to receive documents. We advocate a similar approach, and would require fund companies to deliver initial AIFs and point of sale documents only to those investors who elected to receive them. The documents would, however, be filed on SEDAR. Under the Code of Conduct for Mutual Fund Dealers (see Chapter 4), sales representatives for the fund would have to provide investors with the information necessary to make an informed investment decision, which might include advising investors that the fund's continuous disclosure record contains additional information about the fund.

2. Continuous disclosure

There are two types of continuous disclosure – periodic disclosure and timely disclosure.

Periodic disclosure means that a fund must update its disclosure record at regular intervals, for example by issuing interim and annual financial statements.

Timely disclosure refers to public dissemination of information from time to time when the information meets certain criteria. Currently, mutual funds that are subject to National Instrument 81-102 *Mutual Funds*, which is the majority of funds, must make timely disclosure when there is a "significant change" – a change in the business, operations or affairs of a fund that would be considered important to a reasonable investor in deciding whether to purchase or hold securities in the fund. All other mutual funds must make timely disclosure when there is a "material change" – information that could reasonably be expected to affect the market price of the issuer's securities.

Under our Proposal, fund companies would have to file an AIF for each fund annually and keep the fund's continuous disclosure record current so that all "significant information" was disclosed at all times (see "The disclosure standard" below). Funds would continue to be subject to financial and other periodic disclosure requirements. (See "Disclosure requirements" below.)

Investors would have a statutory right of action for misrepresentations in the continuous disclosure record.

A. The disclosure standard

The disclosure standard determines what must be disclosed, and when. Under the Proposal, a fund company on behalf of a fund would disclose "all significant information" in its entry document (the initial AIF) and in all the fund's continuous disclosure documents, and would have to disclose new significant information as soon as practicable.

The standard is also central to the concept of misrepresentation for mutual funds (from which civil liability flows). Not all errors are misrepresentations. If a fund company, on behalf of a fund, makes an error in the fund's public disclosure, the fund company and its management will not be liable to investors unless the error amounts to a "misrepresentation" – a misstatement or omission of significant information that was necessary so the statement would not be misleading.

Current disclosure standards for mutual funds

The current legislation contains two standards of disclosure for mutual funds – "material fact" and "significant change". Material fact is defined in terms of the significance of impact of the information on the market price of an issuer's securities. Significant change refers to information about a mutual fund that a reasonable investor would want to know.

The definition of significant change is broader than material fact, and the two definitions are used for different purposes:

- Prospectuses require full, true and plain disclosure of "all material facts".
- Timely disclosure must be made when there is "a significant change".
- Mutual funds and other persons cannot trade securities of the issuer if they have knowledge of "a material fact" that has not been publicly disclosed.

The new materiality standard

Under the Proposal, the current definitions of "material fact" and "significant change" would be replaced for mutual funds by the following single definition:

"significant information" means information relating to the business, operations or affairs of a mutual fund that a reasonable investor would consider important in making a decision about whether to purchase or sell securities of the fund.

Discussion

We have chosen the reasonable investor test. There are two primary approaches to defining what is "material": whether the event would affect the market price or value of the securities (the market impact test), or whether a reasonable investor would consider the event to be important (the reasonable investor test). In Canada, the market impact test is used for non-mutual fund issuers, and the reasonable investor test is used for most mutual funds. The US uses the reasonable investor test for everyone.

Although we believe the market impact test is the right one for non-mutual fund issuers, we are proposing to keep the reasonable investor test for mutual funds, primarily because there is no secondary market for most mutual fund securities, and because the value of a mutual fund security is based on the underlying portfolio.

Where the application of the materiality test is not straightforward because of the uncertainty an event will occur, management of the fund company must balance both the probability that the event will occur and the anticipated magnitude of the event in light of the totality of the fund's circumstances to determine if, and when, the information becomes significant information and must be disclosed.

Management's decisions in determining whether information is significant and in timing public disclosure will be viewed in the context of whether management exercised reasonable business judgment based on the information that was available to them at the time the decisions were made.

We have removed the reference to pending decisions. The current definition of significant change includes a decision to implement a change by senior management of the mutual fund or the fund company who believe that confirmation of the decision by the directors of the fund or fund company is probable. We consider this to be more relevant to the issue of when to make timely disclosure, which we would require "as soon as practicable".

This standard of timeliness allows management to make appropriate timely disclosure decisions using the business judgment rule. That is, "Did management exercise reasonable business judgment in determining whether information was significant, based on the information available to them at the time the decision was made?" It would require fund companies to make reasonable inquiries to ascertain relevant information and is consistent with our timely disclosure proposals for CMA issuers (see Chapter 1 of *New Proposals for Securities Regulation*, published in June 2002).

We apply the standard consistently. Under the Proposal, the standard would be applied:

- as the minimum required disclosure in a mutual fund's entry document,
- to determine a mutual fund's continuous disclosure obligations, and
- to determine liability for misrepresentation.

B. Disclosure requirements

The CSA has published for comment a new harmonized continuous disclosure rule, NI 81-106, that will apply to investment funds, which include mutual funds, labour sponsored investment funds, exchange traded funds, split share corporations, closed end funds and scholarship plans. If the proposed CSA rule is implemented, investment funds all across Canada will be subject to the same requirements for ongoing disclosure.

The new CSA rule harmonizes and consolidates all current continuous disclosure requirements into one instrument and also introduces some new reporting requirements that will apply to all investment funds in Canada. The new rule covers financial disclosure, management's report of fund performance (MRFP), AIF disclosure, significant change reporting, and other reporting and disclosure requirements. It also shortens filing deadlines for financial statements and changes the current mandated delivery requirement for financial statements. We will monitor and consider the comments on the CSA rule.

Our Proposal for mutual fund continuous disclosure will be the same as NI 81-106 except, under our Proposals:

- **Non-reporting mutual funds would not have to file financial statements.** Under NI 81-106, non-reporting mutual funds in jurisdictions other than BC would have to prepare and file semi-annual and annual financial statements.

  This is currently a requirement in BC as well. We propose to eliminate the current requirement because it is not consistent with the regulatory treatment of other issuers whose securities are sold under exemptions (the draft rule contains a proposed exception for BC). In addition, investors in non-reporting mutual funds (often called pooled funds) are purchasing the pooled fund securities mostly because of a relationship with a particular investment adviser. This differs significantly from the relationship between investors in retail funds and their portfolio managers.

- **Directors would approve interim financial statements and quarterly fund performance reports.** NI 81-106 requires only a "review". We think that if these statements or reports are to be reviewed by the board, the directors should approve them. There is no standard for a "review".

- **The form of AIF and MRFP would be simplified.** We would propose a more streamlined form of AIF. (The form and related guidelines would be similar in style and approach to the CMA system. See Chapter 1 of our June paper.) Our approach to the form of AIF is described in more detail below. We would also be inclined to take a similar approach to the fund performance report, although there is a stronger argument there for prescription in order to foster comparability of disclosure among funds. Our forms would require the disclosure to satisfy the "significant information" standard.

- **There would be no significant change press release requirement.** NI 81-106 does not make any changes to the current requirements for a mutual fund to announce significant changes by press release and to follow the press release with a significant change report. Under our Proposal, mutual funds using the new disclosure system would have to announce new significant information by filing a notice on SEDAR and then delivering it to investors who have elected to receive fund information. We would eliminate the separate requirement for a press release.

  Our Proposal requires disclosure of significant information "as soon as practicable", which is intended to allow management the time to ensure that the disclosure is accurate and complete.

- **No filing of material contracts would be required.** NI 81-106 would require investment funds to file material contracts and amendments to any material contract not previously filed. We do not intend to require material contracts to be filed with the Commission (see "The AIF" below).

We are particularly interested in comments on the following aspect of the proposed CSA rule:

- **Frequency of fund performance reporting.** NI 81-106 would impose a new requirement for the filing of annual and quarterly MRFPs across Canada. The purpose of the MRFP is to provide up to date information about the fund to current and prospective investors and to advisers and dealers who analyze funds and recommend them to clients. It is expected that this document will be approximately two pages in length for a quarterly report and four pages for an annual report. We are interested in comments about how frequently this report should be prepared and filed.

C. The AIF

Under our Proposals, the AIF would be more important than currently and would play a pivotal role in the integrity of the continuous disclosure record for mutual funds. The AIF would be the document a mutual fund uses both to enter the new system and to consolidate and update all significant information about the fund on an annual basis thereafter. The AIF would require disclosure of all significant information about the mutual fund, its management and any securities being offered. While the form would mandate some specific disclosure, it would prescribe much less detailed disclosure than the current simplified prospectus and AIF.

As under NI 81-101, the AIF would allow investors to compare mutual funds.

A general summary of the form

The AIF under our Proposals would cover the following four topics: the mutual fund, its organization and management, financial information, and fees and expenses.

Discussion about the fund would include the fund's fundamental investment objectives, investment strategies, suitability, risk factors and income tax considerations as well as a description of the securities. It would also include a description of the distribution policies and the procedures for purchases, switches and redemptions.

Discussion of the organization and management of the fund would include disclosure about the fund company and its directors and senior officers as well as the trustees if it is a trust. It would also include disclosure about the fund's operations, its fund governance practices and who administers each function (i.e. the service providers, including the portfolio manager, custodian and sales force). Any sales incentives and conflicts of interest arising in the organization and operation of the mutual fund would also be disclosed.

The financial disclosure would include information about how portfolio securities will be valued and the net asset value of the securities calculated. Disclosure of performance data would still be subject to similar rules as exist today in NI 81-102.

The fees and expenses discussion would include information about the management fees, any management fee rebate or distribution programs, fund expenses indirectly borne by the investor, dealer compensation, and illustrations of different purchase options. The calculation of management expense ratios would be subject to similar rules as exist today under NI 81-102.

Some changes from the existing simplified prospectus and AIF

These are some of the more significant differences between our vision of a new form of AIF and the simplified prospectus and AIF required under NI 81-101:

- **Material contracts.** A fund company on behalf of a fund would no longer specifically disclose or file its material contracts, although we would remind fund companies that the terms and conditions of key contracts are often significant information that must be disclosed.

- **Certificates.** We would not require certificates. A certificate is a mechanism to establish civil liability that we do not view as necessary because fund companies would have statutory liability for misrepresentations in the mutual fund's continuous disclosure on an ongoing basis under the new system.

- **Statement of investors' rights.** We would change the prescribed statement about an investor's rights to reflect the new investor rights that we are developing.

3. Restricted mutual funds

We propose that the classes of investors in a restricted mutual fund, meaning a non-public mutual fund, be a modified list of those described in Multilateral Instrument 45-103 *Capital Raising Exemptions* (adopted by BC and Alberta in April 2002) and in the current exemptions:

- Accredited investors (financial institutions, pension and investment funds, substantial corporations and wealthy individuals)
- Employees and consultants of the fund company, its affiliates and advisers[2]
- Clients of an adviser who buy securities of in-house pooled funds of the adviser

Neither the "family, friends and business associates" exemption nor the offering memorandum exemption contained in MI 45-103 would be available to mutual funds. Both exemptions are to assist new or junior issuers in raising capital. This reasoning does not apply in the mutual funds context. Funds that are currently relying on either of these exemptions would be grandfathered or transitioned.

A restricted mutual fund that wants to sell its securities to the public would have to enter the system for public mutual funds.

The addition of pooled funds as a form of restricted mutual fund is a change from the current situation. Currently, advisers who want to distribute securities of an in-house pooled fund to their clients must fit within one of the exemptions from the prospectus requirements or file a prospectus. We use the term pooled fund to refer to unit trusts where an adviser invests and manages money of the adviser's clients.

Advisers use pooled funds because they provide greater efficiencies in managing client assets. A client of an adviser buys units of the pooled fund solely because of the client's decision to obtain discretionary money management services from the adviser. Pooled funds are the means by which the adviser chooses to provide these services and can be considered an extension of the adviser.

We view the relationship between the client and the adviser as the area that needs to be regulated, not the sale of securities of the pooled fund. Consequently, we propose that trades of securities of in-house pooled funds to clients of the adviser be permitted under the concept of restricted mutual funds.

[2] We will be recommending that the current "portfolio manager" and "investment counsel" registration categories be combined into one adviser category. "Adviser", in this Chapter, means "portfolio manager".

4. Foreign-regulated mutual funds

Currently, foreign mutual funds selling securities in Canada must either file a prospectus and comply with the product regulation requirements of NI 81-102 or rely on an available exemption. If a foreign mutual fund files a prospectus and becomes a reporting issuer, it is also subject to Canadian continuous disclosure requirements. This imposes additional costs on foreign funds, which are already incurring the costs of complying with their home regime. This also creates a barrier to entering the Canadian market, which reduces investment opportunities for Canadians.

In our February paper, we questioned whether foreign mutual funds regulated under a credible regime of regulation in their home jurisdiction should be allowed to sell their funds in Canada using the documents from their home jurisdiction with certain additional disclosure.

Industry questioned whether the disclosure would be sufficient to protect Canadian investors and noted that the comparability of funds, which was one of the goals of NI 81-101, would be lost. This would also be unfair to the foreign mutual funds that have expended money and time to access the Canadian markets.

We are persuaded by this reasoning and propose that Canadian investors be permitted to buy foreign mutual fund securities only where there is no solicitation by the fund of Canadian investors and certain disclosure is provided. The additional disclosure would include information about the risks of making such investments, such as foreign law problems that may arise, the lack of protections of Canadian regulation, and possible adverse tax consequences. This concept would be put into effect by exemptions from the continuous disclosure requirements applicable to mutual funds and the Code of Conduct for Fund Companies (see Chapter 2) and a registration exemption for foreign registered dealers. The registration exemption would be subject to the same limitation as the foreign mutual funds, i.e. no solicitation (see Chapter 2, Part 5 of our June paper).

If Canadian investors choose to invest in foreign mutual funds, however, they will not have the protections of Canadian law. Our responsibility to protect Canadian investors does not extend to protecting them when they voluntarily and without solicitation choose to buy a foreign fund.

We would provide guidance on what constitutes solicitation along these lines:

- Solicitation includes any promotional activity directed specifically at Canadian residents or foreign investors generally.

- Solicitation does not include mere exposure of the foreign mutual fund to Canadians through normal-course advertising that a Canadian might happen to see (for example, the mutual fund’s website, or advertising on US television channels carried by Canadian cable or satellite companies).

CHAPTER 2
CODE OF CONDUCT: FUND COMPANIES

In Chapter 2, Part 1 of *New Proposals for Securities Regulation*, published in June 2002, we explained the background to the code of conduct approach we propose for registrants. That Chapter also contained a draft Code for investment dealers. You can find a copy of the June paper at www.bcsc.bc.ca/bcproposals.

The following Code would apply to mutual fund companies and, except for Principle 9 (Compliance systems), to representatives of those companies. We believe this Code would be necessary to recognize the central role fund companies play in the operation of mutual funds. Under the Code, fund companies would be subject to a regime of principles-based regulation that would eliminate the need for many of the current detailed business conduct and product regulation rules. The Code would be located in the *Securities Rules*.

When we say "fund company" we are referring to the entity (usually a corporation in the financial services or mutual fund industry) that is responsible for all aspects of managing the mutual fund including providing portfolio management and distribution services to the fund, whether internal or outsourced. Fund companies are sometimes referred to as "manufacturers" or, as in National Instrument 81-102 *Mutual Funds*, "fund managers".

Fund companies do not have to register with the Commission to perform those functions. However, they must register if they perform advising or trading functions.

For example, if a fund company manages the investment portfolio of a fund internally, the fund company will be registered as a portfolio manager. If the fund company sells directly to the public, it will be registered as a mutual fund dealer. Fund companies that engage in these activities would also be subject to the Codes that apply generally to registrants engaged in those activities: the Codes for Advisers and for Mutual Fund Dealers (see Chapters 3 and 4).

Many fund companies hire service providers such as portfolio managers, custodians and distributors, to carry out various functions. As a fund company, you would have to ensure that you and your funds comply with this Code. Therefore, you would want to consider the Code when negotiating contracts with your service providers; we have included examples of the type of provisions you might want to include in these contracts in the Guidelines to Principle 1.

This Code contains Principles about the activities of fund companies, including Principles for managing a fund's assets (Principles 7 and 8), which we believe to be the most fundamental of a fund company's activities. Those Principles relate to liquidity, risk and valuation and would also apply to advisers that manage fund assets.

The use of derivatives does not avoid the requirements of this Code. The Code applies both to direct conduct and to conduct effected through transactions that have the same indirect result or economic effect.

Failure to follow the Principles set out in the Code could result in criminal liability, regulatory sanctions and/or civil action for fund companies and their representatives.

The Investment Funds Institute of Canada (IFIC) has codes and guidelines for its members, many of which relate to issues that mutual fund companies face. You are encouraged to review these codes and guidelines, which include *Guidelines for a Mutual Fund Manager Code of Ethics*, the *IFIC Privacy Code* and the *Model Code of Ethics for Personal Investing*.

The provisions of this Code that would appear in the Rules are in bold face type. The paragraphs that follow each Code provision would appear in the Guidelines.

In this Code, when we say "clients", we mean the investors or potential investors in your mutual funds. When we refer to a fund's "public disclosure record" we mean the fund's annual information form (AIF) and its continuous disclosure record.

Principle 1 – Standard of care and integrity

Code and Guidelines

1. **Exercise the powers and discharge the duties related to your management of a mutual fund honestly, in good faith and in the best interests of the mutual fund.**

2. **Exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.**

Sections 1 and 2 of Principle 1 set out the standard of care you must meet in managing your funds, including managing or arranging for the management of the assets of the funds you manage. You have a duty to act honestly, in good faith and in the best interests of your fund. An example of conduct that would not meet the necessary standard of care includes valuing your fund's net assets at a value that does not reflect the current market value of those assets (see also Principle 8).

3. **Comply with all relevant laws and regulations that govern you.**

You must keep informed of the laws that govern your business and you must follow them. Apart from securities laws, these laws could include federal proceeds of crime and anti-terrorist legislation.

4. **Your conduct must not bring the reputation of the securities market into disrepute.**

Examples of conduct that would violate this Principle include various types of market manipulation, like the following:

- Wash trading
- High closing
- Front running by one of your representatives

5. Ensure that service providers handling fund assets comply with this Code.

Many fund companies hire service providers such as portfolio managers, custodians or securities lending agents, to carry out functions that involve handling fund assets. While a portfolio manager is subject to the Code of Conduct for Advisers, other service providers that handle fund assets are not subject to their own codes.

It is your responsibility to ensure that a service provider that handles fund assets complies with this Code. You should consider the Code when negotiating contracts with your service providers; you may want to include provisions that help you ensure that they do not engage in activities that will result in breaches of the Code. Such provisions include the right to examine their records or to conduct on-site inspections and to require remedial action when necessary. You may also want to establish a standard of care in your contracts with these service providers.

6. A fund company must not exclude or restrict any duty or liability it may have under this Code.

For example, neither your fund's public disclosure record nor any agreement you have with retail clients can purport to exclude the application of this Code.

Discussion

Principle 1 of the Code and the accompanying Guidelines would replace:

- **Act, s. 125 *Standard of care for management of mutual fund***

This section contains the existing standard of care for all persons involved in the management of a mutual fund. Sections 1 and 2 of Principle 1 would replace it.

- **Act, s. 128 *Trades by insiders***

This section prohibits use of information about the investment program of a fund to buy or sell securities for the person's benefit. Sections 1 and 2 of Principle 1 would replace it.

- **National Instrument 81-102 *Mutual Funds* (Sections 2.10, 2.15, 4.4, 6.6 and 8.1)**

Sections 2.10, 2.15, 4.4 and 6.6 of this instrument set out standards of care for the fund company and various service providers, including derivatives advisors, securities lending agents and custodians. Sections 1, 2 and 5 of Principle 1 would replace these provisions.

Section 8.1 of this instrument only permits contractual plans that existed on February 1, 2000. This provision is not necessary as these plans, which allow investors to buy funds by installment but pay all on-going sales charges up front, would likely violate the prohibition against unfair practices under securities law (see Chapter 4 of *New Proposals for Securities Regulation,* published in June 2002). Unfair practices include imposing inequitable terms and conditions. These plans are inequitable because the investor bears the sales charges before having any significant assets invested to earn returns, unlike the conventional front-end load, where the sales charges are deducted up front but the balance of the funds are immediately invested. We would consider providing grandfathering or transitional relief for any plans still in existence.

Principles 1, 4, 5, 7, 8 and 9 would replace large parts of this instrument. Other portions of the instrument would be replaced by the Codes for Advisers and Mutual Fund Dealers (see Chapters 3 and 4) and by the mutual fund distribution proposals discussed in Chapter 1. Therefore, we could eliminate the majority of NI 81-102. While we would maintain some of the substance in Parts 5, 6, 10, 11 and 14 through 16, we would simplify and streamline them where appropriate.

Principle 2 – Proficiency

Code and Guidelines

Maintain the proficiency necessary to properly manage your funds.

The Commission does not set proficiency standards for mutual fund companies. However, companies are expected to have programs in place to ensure that those who undertake critical aspects of management of their funds are appropriately qualified. For example, if your funds invest in illiquid assets, you will need qualified people, on staff or contracted, to properly value those assets (see also Principle 8).

Only appropriate personnel should hold positions of trust and key staff must be competent to perform their roles. When key functions are outsourced, fund companies should do appropriate due diligence to ensure that the suppliers chosen have sufficient expertise and experience to perform their functions.

In a rapidly changing financial marketplace, it is important to keep abreast of changes in products, regulations and other factors that will affect your ability to provide high standards of service to your funds. Education, especially continuing education, is a necessary component of skill.

Discussion

Principle 2 of the Code does not replace any existing provisions.

Principle 3 – Fund governance

Code and Guidelines

1. **Ensure you have a governance structure that is suitable for the structure of your funds and that addresses the conflicts of interest you face.**

2. **Those responsible for the governance of your funds must ensure that management has appropriate compliance systems in place to deal with conflicts of interest.**

3. **Disclose your governance practices, including the identity of members of your governance body, the roles and responsibilities of that body, and whether that body is independent of the fund company, in your fund's public disclosure record. Include a comparison of your governance practices with published industry practice guidelines.**

There are many different models of governance and you must choose one that is appropriate for your business and your funds.

Traditionally, most fund companies in Canada have used an in-house governance model. In many cases, the fund company's board of directors, or a committee of that board, has performed the governance function by monitoring the relationship between the fund company and its funds.

More recently, some fund companies have moved to a more independent governance model. In this model, the governance body is sometimes an advisory board or board of governors with independent members, or an individual or corporate trustee independent of the fund company.

An independent agency can focus on conflict of interest issues from the fund's perspective. This can be useful if there are many conflicts that arise frequently and the fund company's directors have ties to related parties. For example, a fund that is part of a large group of firms providing a wide variety of services to the marketplace, such as underwriting and dealing in securities, may conclude that an independent fund governance agency is the best means of addressing the conflicts inherent in those relationships. Funds with less frequent conflicts and less complex relationships may conclude that the fund company's board can provide adequate governance for their funds. Remember that where the board acts as the fund company's governance agency, an individual's fiduciary duties to the company may sometimes conflict with his or her duties as a member of the governance body. These conflicts may be difficult to manage.

Whichever structure you choose, the governance body will be responsible for monitoring areas of potential conflicts, both real and perceived, to ensure that the fund company complies with the conflict provisions of the Code (primarily Principles 1 and 4) and exercises its discretion in the best interests of the fund. The governance body will be in the best position to show it has met its responsibilities if it establishes guidelines that cover the scope and processes it uses to conduct this oversight. These processes could include:

- Reviewing and commenting on the fund company's policies dealing with conflicts (e.g. policies relating to soft dollars, brokerage allocations and related party transactions).
- In limited circumstances, approving specific decisions to participate in transactions involving related parties or their affiliates.
- Reviewing periodic compliance reports from the compliance group at the fund company about related party transactions and other conflict situations.

You may decide to use the governance body for other functions. This will obviously occur where the governance agency is the fund company's board. However, it could also occur with independent agencies.

While each fund must have effective governance, that does not mean that each fund must have a separate governance body. You will need to consider whether a single body can provide effective governance to all of your funds. You will also need to consider the appropriate number of members to ensure that your governance body is effective.

Disclosure of your fund's governance practices against industry practices will enable investors to consider this information in their overall assessment of your funds. Investors may expect you to explain the reasons for any material variations between your practices and those set out in industry guidelines.

Note to Reader:

This disclosure requirement assumes that industry will have published practice guidelines. We recognize that industry guidelines do not currently exist. However, if this approach to governance is adopted, we would work with industry and other regulators in developing guidance.

Discussion

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

The Canadian Securities Administrators (CSA) Concept Proposal published in late February 2002 addressed the issue of fund governance dealt with in Principle 3 of the Code. CSA proposed a system for mutual fund governance that would see fund companies creating a governance agency for the funds they manage. The comment period closed on June 7, 2002 and CSA is considering the comments received. We reviewed these comments in developing our approach.

The CSA Proposal sets out five pillars of a new approach to regulating mutual funds and their fund companies (the CSA Proposal refers to these entities as “managers”): registration of fund companies, mutual fund governance, product regulation, disclosure and investor rights. In its discussion of governance, CSA articulated principles that governance agencies for mutual funds would follow. Central to these is the independence of the agency from the fund company; the CSA Proposal suggests an independent agency be made mandatory to oversee a fund company’s management of its mutual funds and to minimize conflicts of interest.

Principle 3 of our Code would require a fund company to establish a governance structure that is appropriate for its funds. We would not mandate the use of an independent agency, although in the Guidelines we suggest circumstances in which fund companies should consider independent governance. We would not mandate independent governance because we believe it has yet to be demonstrated that the benefit to investors would outweigh the significant related costs. We are also not convinced that mutual fund company conflicts are being resolved inappropriately. Perhaps this is because, as a practical matter, a mutual fund company that routinely resolved conflicts to the detriment of investors would likely go out of business. As long as funds are required to disclose conflicts and how they resolve them, investors could assess their importance, with the assistance of advisers, analysts and the financial media.

The CSA Proposal indicates that the role of the governance agency is to oversee the actions of the mutual fund company to ensure it acts in the best interests of investors. While we would allow fund companies to determine whether an independent governance structure is necessary for their funds, we agree with CSA’s statements about an agency’s oversight role.

The CSA Proposal sets out eight specific responsibilities for the governance agency. Describing these specific responsibilities could deal with concerns about fragmentation in the market and investor confusion over varying governance structures. However, we believe that fund companies are in a better position than regulators to determine the appropriate responsibilities for their governance body. Our approach would require the governance body to ensure management has appropriate compliance systems in place to deal with conflicts of interest and would require disclosure of governance practices in a fund's public disclosure record. In this way, investors could choose whether they are comfortable with the governance structure proposed for any particular fund.

We also believe there is a risk that some areas of responsibility identified in the CSA Proposal could blur the line between the respective responsibilities of management and the governance agency. These are areas such as approving benchmarks, monitoring performance, monitoring adherence to investment objectives, and acting as audit committee for the funds.

Requiring the governance agency to monitor investment performance and adherence to objectives could be seen as necessary for the best interests of the fund. However, we believe that because the fund company would be subject to a standard of care that requires it to act in the best interests of the fund, the fund company could appropriately deal with investment and performance issues.

Requiring the agency to act as audit committee could overlap the function of the fund company. A fund company that is a public company could have its audit committee review fund financial statements and recommend them to the board. Fund companies that are not public would need to determine an appropriate structure for financial statement review.

The CSA Proposal lists other responsibilities that we do not think need to be set out separately. While the governance agency would likely meet with management and establish a charter, this does not need to be specifically mandated. Under our Code approach, we have set out the general Principles that fund companies must follow and, in the Guidelines, have given examples of particular processes governance bodies could adopt.

The CSA Proposal addresses a number of matters in addition to governance. On the issue of appropriate minimum standards for fund companies, it proposes fund company registration as the way to impose those standards. We have taken a different approach – rather than require registration, we will deal with these issues through the Code. We deal with most of the remaining issues covered by the CSA Proposal in Principles 7 and 8 of this Code (product regulation) and in Chapter 1 (disclosure). We are currently considering civil liability (investor remedies) for all our proposals, including mutual funds, in light of the comments we have received on our June paper, the civil liability provisions recently introduced in the Ontario legislature, and our own further study.

Principle 4 – Conflict of interest

Code and Guidelines

1. **Resolve all significant conflicts of interest in favour of the fund using fair, objective and transparent criteria. If there is a conflict of interest between funds, use fair, objective and transparent criteria to resolve those conflicts. In both cases, apply the criteria consistently.**

Conflicts of interest arise frequently in the mutual funds industry. Some conflicts can be avoided through adopting proper procedures while other conflicts are unavoidable in the context of normal business practice and should be managed as they occur.

Fund companies typically face three different types of conflict situations:

- Conflicts between the fund company and the fund itself
- Conflicts among funds
- Conflicts arising from a fund company's relationship with others in a related group

Conflicts between the fund company and the fund

Principle 4 makes it clear that the interests of the fund always come first. (This should be interpreted in the context of reasonable commercial practice – an extreme interpretation would suggest that you could not charge a fee to a fund.) The best way to ensure that the client's interests are put first is to have appropriate procedures in place to ensure that all conflicts of interest between you and the fund are resolved in favour of the fund and to have a system that effectively monitors and enforces compliance with those procedures. These procedures should cover conflicts of interest arising in the context of allocation of expenses, assets and resources.

You have the onus of showing that you acted in the best interests of the fund. Examples of circumstances where it may be difficult to meet this onus include:

- Arrangements to which you are a party where clients are required or expected to deal with a particular financial institution or to buy particular products or services to be able to buy your mutual fund ("tied selling").

- Using fund assets to pay expenses that are properly yours. For example,

  - "Soft dollar" arrangements – arrangements where brokers accept commissions as payment for goods or services other than order execution or related services – create the perception that the portfolio may be bearing higher execution costs than would otherwise be the case.

  - Having your mutual funds indemnify you or pay insurance costs for actions by you or your service providers that would violate the standard of care set out in Principle 1.

Examples of situations where it may be difficult for a representative of a fund company to show that he or she put the interests of the fund first include:

- Having a personal interest in a proposed business activity of the fund, such as arranging for the fund to invest in a mortgage that you or a related party had an interest in.

- "Front running", that is, using information you acquired about a fund's future trading intentions, possibly through oversight of the portfolio manager, to buy or sell in advance of the fund executing those intentions.

- Serving on the board of directors of a public issuer or a privately held company raising capital in the exempt market. This raises several potential conflicts, including conflicting duties to the company and the fund, potential exposure to inside information, and conflicting demands on your time.

See IFIC's *Guidelines for a Mutual Fund Manager Code of Ethics* for other examples of inappropriate practices.

Conflicts between funds

Sometimes the conflict of interest is not between the fund company and a fund, but between funds. This is best resolved if the fund company has appropriate procedures in place to deal with these situations, and a system to monitor and enforce compliance with those procedures.

Examples of circumstances that can lead to conflicts between funds include:

- Deciding how to allocate investment opportunities or expenses among funds. This does not mean that all funds must have equal access to an offering of securities; it is open to a fund company to vary the allocation according to objective standards.
- In a fund of fund transaction, deciding how to allocate acquisitions or redemptions among underlying funds, particularly where some but not all of the underlying funds are related to the top fund.

The fund's public disclosure record must contain the guidelines for making these decisions.

Conflicts arising from relationships with others in a related group

Sometimes the conflict of interest, real or perceived, arises because the fund company is one of a number of companies within a related group. These conflicts can be addressed in several ways. In each case, you must put the interests of the fund before your own interests or the interests of an entity that is related to you.

Examples of conduct that would make it difficult for you to show that you acted in the best interests of the fund include:

- Buying securities from a related party or entering into other transactions with a related party on terms other than normal commercial terms between arm's length parties.
- Acting as purchaser of last resort if a related party was unable to sell underwritten securities to any other purchaser.
- Paying an undisclosed, or not commercially reasonable, fee to a related party.

2. Disclose all conflict situations, including all fees, compensation and incentive structures.

You should include this information in the public disclosure record of your funds. This disclosure would include fees that the fund pays to you as a fund company or fees or compensation that you intend to provide to dealers who sell your funds.

Investors in your funds are entitled to know what fees the fund is paying directly. These include your management fees and any incentive fees. You should disclose clearly the basis on which these fees are calculated and whether incentive fees are tied to a particular benchmark or index. In a fund of fund situation, you should also disclose the consolidated management expense ratio.

Investors are also entitled to know if you are providing compensation, such as trailing commissions, or incentives to dealers who sell your funds. These include any incentive structures you put in place to reward those who sell your funds. In the past, some of these structures led to rewards that were seen as so extravagant that reasonable people questioned whether the dealers were able to provide objective advice. You should consider the impact of these practices on the reputation of the mutual fund industry and clearly disclose all compensation and incentive arrangements.

Examples of incentive structures that you must disclose include:

- Any benefits, including trips for example, conferred on dealer representatives that meet a particular sales threshold.

- Paying a higher rate of commission or trailing commission if representatives meet certain sales thresholds.

- Providing financial assistance to dealers, their representatives or associates based on their selling your funds. Dealers receiving financial assistance, and certain of the other incentives listed above, will need to consider if they can do so without breaching their obligations under the Code that applies to them.

3. Develop conflict of interest procedures and disclose them in the fund's public disclosure record.

You must develop conflict of interest procedures that address the conflict situations that arise in your particular business. In some cases, disclosure in the fund's public disclosure record may be sufficient (e.g. management or incentive fees). In others, those who are responsible for your fund's governance may need to review the conflict (see Principle 3). In the most serious cases, you may conclude that it is simply impossible to manage the conflicts and the situation should be avoided completely, for example, tied selling or the use of soft dollars in ways that do not benefit the fund.

Discussion

Principle 4 of the Code and the accompanying Guidelines would replace:

- **Act, s. 120 *Definitions and interpretation***

This section contains definitions and interpretation for Part 15 of the Act *Self dealing*. Since the Code would replace Part 15, the definitions would no longer be necessary.

- **Act, s. 121 *Investments of mutual funds***
- **Act, s. 122 *Indirect investments***
- **Act, s. 123 *Relieving orders***

Section 121 prohibits a mutual fund from entering into certain transactions, including loans and investments to or in related parties or substantial security holders. This section could be eliminated because Section 1 of Principle 4 would require all significant conflicts to be resolved in favour of the fund.

Section 122 prohibits a mutual fund, a fund company or its mutual fund distributor from entering into a contract or other arrangement that results in liability for an investment prohibited by section 121. Section 123 allows the Commission to grant exemptions from sections 121 and 122. Sections 122 and 123 would be unnecessary once we eliminate section 121.

- **Act, s. 124 *Fees on investment for mutual fund***

This section prohibits a mutual fund from investing where a related person will receive a fee or other compensation unless the relevant contract is disclosed in the fund's simplified prospectus or the Commission grants exemptive relief to allow the investment. This section could be eliminated because Section 1 of Principle 4 would require all significant conflicts to be resolved in favour of the fund and Section 2 of Principle 4 would require disclosure of all fees and compensation.

- **Act, s. 127 *Restrictions on transactions with responsible persons***

Under this section a mutual fund may not, and a fund company may not cause a mutual fund to: (i) invest in any issuer in which a fund company has a common partner, officer or director unless this fact has been disclosed to the mutual fund security holders, (ii) buy or sell the securities of any issuer from or to the account of a fund company, or (iii) make a loan to a fund company. This section could be eliminated because Principle 4 would require fund companies to resolve all conflicts in favour of the fund and to disclose all conflict situations.

- **National Instrument 81-102 *Mutual Funds* (Sections 2.5, 2.10, 2.15, 3.3 and 6.6 and Parts 4 and 7) and related Companion Policy and BC Notice 2002/31 *Publication for Comment of Proposed Fund of Fund and Other Amendments to the Mutual Fund Rules***

Section 2.5 of this instrument limits the amount a mutual fund can invest in other mutual funds. This raises several issues, most of which can be dealt with by disclosure. The remaining issue is the conflicts that may arise between the top fund and the bottom funds. While the new CSA "fund of fund" proposal described in BCN 2002/31 significantly relaxes existing rules, we believe that Principle 4 would go further, making the fund of fund proposal unnecessary.

Sections 2.10, 2.15, 4.4 and 6.6 provide that the mutual fund cannot reimburse the fund company and various service providers, including derivatives advisors, securities lending agents and custodians, for actions that violate the relevant standard of care. Section 1 of Principle 4 and Section 5 of Principle 1 would replace these provisions.

Section 3.3 provides that none of the costs for starting a new mutual fund can be charged to the mutual fund or its investors. Under Principle 4, it would be very difficult to show you acted in the best interest of the fund if you use fund assets to pay your own expenses. Start-up costs for new funds may be an example of this.

Part 4 prohibits a number of specific transactions and investments. Section 4.1 prohibits the fund from investing in an offering for 60 days if a dealer related to the fund company underwrote the offering, and prohibits investing in a company with related directors, officers or employees. Section 4.2 prohibits various transactions between a mutual fund and a related party. Section 4.3 provides an exemption for transactions where the fund is paying market price. Principle 4 would replace all of these provisions, without the constraints on business that the current broader prohibitions impose.

Part 7 prohibits payment of an incentive fee unless it is calculated with reference to a well-known benchmark or index and follows other prescribed requirements. Principle 4 would replace this Part as it would require the interest of the fund to be put first and requires disclosure of the basis for any fees that are paid, including incentive fees.

- **Multilateral Instrument 81-104 *Commodity Pools* (Part 5)**

Part 5 of this instrument exempts commodity pools from Part 7 of NI 81-102 and allows commodity pools to pay incentive fees based on the cumulative total return of the commodity pool, rather than on a well-known benchmark or index. This specific relief would no longer be required as incentive fees would be permitted so long as they were disclosed.

- **National Instrument 81-105 *Mutual Fund Sales Practices* (Sections 2.1, 7.1(3), 7.2 – 7.4 and 8.3 and Parts 3, 5 and 6) and related Companion Policy**

This instrument prohibits certain sales practices and compensation arrangements for mutual fund industry participants. It was intended to set minimum standards of conduct for these industry participants when distributing mutual fund securities, and to ensure that investors' interests were put first. It was designed to minimize conflicts between the interests of industry participants and those of investors.

Section 2.1 prohibits a fund company from paying money or giving benefits to dealers or their representatives, except in accordance with the instrument. Part 3 does not allow rates for commissions and trailing commissions to vary based on the amount of a fund the dealer has sold, the amount the dealer's clients hold, or the time of year when commission is earned on sales of the fund units. Part 5 deals with marketing and educational practices, including paying to send dealer representatives to industry conferences. Sections 7.1(3), 7.2 and 7.3 prohibit commission rebates, financial assistance and charitable donations. The disclosure required by Section 2 of Principle 4 addresses all of these practices.

Part 6 of this instrument prohibits reciprocal commissions. Section 7.4 prohibits tied selling. It is difficult to see how a fund company that was a party to a reciprocal commission where fund assets were indirectly used to pay fund company expenses, or a fund company that took part in tied selling arrangements, would be resolving conflicts in favour of the fund as Section 1 of Principle 4 would require.

Section 8.3 of the instrument requires a mutual fund that does not have a current prospectus to give each purchaser a document disclosing compensation, sales practices and cross ownership with related parties before a trade. The disclosure required by Section 2 of Principle 4 together with the disclosure in the fund's AIF would disclose the same information to investors.

We believe the conflict of interest provisions in Principle 4 would be more likely to focus fund companies on the balance between effective and fair compensation and the interests of their funds.

While Principle 4 would replace only those parts of NI 81-105 relating to fund companies, the separate Codes for Advisers and Mutual Fund Dealers (see Chapters 3 and 4) would deal with the remaining issues in the instrument. Therefore, we could eliminate the entire instrument.

- **BC Instrument 81-504 *Transactions Between Mutual Funds and Responsible Persons Relating to Certain Debt Securities, Mortgages, and Equity Securities***

This instrument provides relief from the self dealing prohibitions in section 127 of the Act for certain transactions between related parties. Since Principle 4 replaces section 127, we can eliminate this instrument.

- **National Policy 29 *Mutual Funds Investing in Mortgages***

NP 29 regulates mutual funds that invest in mortgages. It prohibits investment in mortgages on property that an officer, director or trustee of the fund, fund company or related party has an interest in and sets out the price at which the fund can acquire mortgages from non-arm's length persons. Principle 4 would address these issues while Principles 7 and 8 would cover other aspects of NP 29. Therefore, we could eliminate the entire policy.

- **CSA Notice 92/1 *Soft Dollar Transactions***

This notice discusses various types of soft dollars and describes the sort of transactions that cause concerns. Principle 4 would eliminate the need for this notice.

Principle 5 – Dealings with clients

Code and Guidelines

1. Ensure that your records accurately disclose the fund units that each client or dealer holds and ensure that this information is provided to clients.

Your records must be complete and up to date relating to the securities of your fund that are held by each client or dealer. You should develop a process to ensure records are updated to reflect dividends or other distributions from the fund. A mutual fund that is a corporation can satisfy this requirement by complying with the record keeping requirements of the applicable corporate legislation.

You should ensure that clients are provided with details about their holdings and any dividends and other distributions. In some cases, your records will disclose only the identity of the dealer whose clients own your funds rather than the identity of the ultimate investor. In those circumstances, you can rely on statements that dealers send to their clients.

If your records disclose the identity of individual clients, you can either rely on dealers to send records to their clients or provide those clients with statements showing the balance they hold and any changes made since the last statement. If you do provide these records directly, mutual fund dealers will be entitled to rely on your statements and will not need to send statements of their own, subject to any rule that their self-regulatory organization imposes.

You will also need to provide clients or dealers with information necessary for clients to prepare their income tax returns.

2. Safeguard any monies you hold and ensure they are used for their intended purpose. Manage purchases and redemptions as disclosed in your fund's public disclosure record.

To safeguard monies you receive for the purchase of fund units, you should invest the funds as soon as practicable after you received the purchase order, subscription proceeds and any required information. Similarly, redemption proceeds should be paid promptly to the client.

Your fund's public disclosure record can set out particular requirements for purchase and redemption, including what documents you require. It can also set out when you can reject purchase orders or suspend redemptions.

3. Ensure that all disclosure you provide to clients is prepared using plain language and is presented in a format that assists in readability and comprehension.

Plain language helps investors understand your disclosure. Used in a fund's public disclosure record, it will encourage investors to read the disclosure and help them make informed investment decisions. Used in other statements clients receive, it will ensure that they understand the securities they hold, the processes to deal with those securities, and their relationship with you or the fund.

Examples of "plain language" techniques include:

- Short sentences
- Definite, everyday language
- Using the active voice
- Organizing the document in clear, concise sections, paragraphs and sentences
- Avoiding legal or business jargon and boilerplate wording

Discussion

Principle 5 of the Code and the accompanying Guidelines would replace:

- **National Instrument 81-102 *Mutual Funds* (Parts 9 and 18) and related Companion Policy**

Part 9 of this instrument sets out detailed requirements relating to buying mutual fund units. Part 18 deals with record keeping for mutual funds that are not corporations. Principle 5 would deal with these issues and replace those provisions as they apply to fund companies.

While Principle 5 would also deal with redemptions to some extent, more detailed rules are likely required in this area. Therefore, we would retain and simplify Part 10 of NI 81-102, which deals with redemption of mutual fund securities.

Principle 6 – Confidentiality

Code and Guidelines

Hold in strict confidence all confidential information acquired in the course of the relationship with clients of your funds, unless the client consents to the disclosure, the disclosure is required by law, or the client appears to be engaging in activity that threatens the integrity of the securities market.

In the course of operating a mutual fund, you may receive information about the financial circumstances of clients and prospective clients of your fund. You must keep that information in confidence. Receiving such information places you in a position of trust and responsibility and it is unethical to betray this trust. If information is disclosed, the damage to the client is the same whether or not the disclosure was intentional.

You may disclose the client's confidential information in only three situations.

First, you may disclose information if you get the client's consent, preferably in writing.

Second, you must disclose if you are required to do so by law. Legal requirements include legally enforceable requests for information from the Commission and provisions of Canadian money laundering and anti-terrorist legislation.

Third, you may disclose the client's confidential information to the extent necessary to help regulators deal with situations where you become aware that the client is engaging in activity that threatens the integrity of the markets.

Discussion

Principle 6 of the Code does not replace any existing provisions.

Request for Comment: The next two Principles (7 and 8) relate to the management of each fund and replace existing product regulation provisions. They are closely connected.

We are seeking comment on whether to replace much of the current prescriptive product regulation requirements with the more general principles set out below.

If adopted, these Principles would apply both to the fund company and to advisers that manage fund assets.

Principle 7 – Liquidity and risk management

Code and Guidelines

1. **Maintain sufficient liquidity in each of your funds so that the funds can meet all redemption requests on demand or within a specified period after demand.**

2. Manage the risk in your funds to meet the specific risk parameters disclosed for each of your funds.

Note to Reader:

We have not included detailed guidance on these Principles but recognize that guidance would be necessary. If a principles-based approach to product regulation is adopted, we would work with industry and other regulators to develop appropriate guidance for risk and liquidity.

The Guidelines to Principle 7 would make it clear that the ability to meet investor redemptions on demand is the essence of a mutual fund, and that funds must maintain sufficient liquidity to do this. In the event of a market catastrophe, the Commission would consider granting any necessary relief from this Principle.

Under a principles-based approach, we would expect to rely more on disclosure than on prohibitions. We expect the Guidelines to Principle 7 would deal with issues such as:

- Diversification
- Concentration and control
- Risky and illiquid asset classes (such as real property, unlisted securities and commodities)
- Business practices that affect liquidity and risk (such as short selling, purchasing securities off-market, leveraging and lending of portfolio assets)
- The use of derivatives

We anticipate that the Guidelines would allow existing practices to continue in such areas as securities lending, using derivatives and investing in commodities.

Discussion

The move to a principles-based approach to investment restrictions has a precedent in Canadian financial regulation. In regulating the investment practices of insurance companies, trust companies and pension funds, Canada has moved away from specific quality tests for investments, known as “legal-for-life” rules, to a “prudent person” approach, which allows more flexibility in investments. The new approach has been in place for several years and works well. The sections dealing with liquidity and risk in Principle 7 would adopt a similar approach for mutual funds.

We are not unique in proposing a principles-based approach to mutual funds – Australia has adopted one as part of a broader scheme of regulation that covers not just mutual funds but all collective investment schemes, such as project financings, film financings and syndicated mortgages. The Australian approach is described in Appendix A.

There are some differences between the Australian approach and what we propose:

- In Australia, the fund company must be registered. We believe that the main issue is to ensure that appropriate responsibilities are imposed on fund companies, and that doing so through a Code of Conduct is equally effective for that purpose and less costly than the creation of a new registration regime.

- In Australia, the fund's "compliance plan" must be filed and audited externally and is subject to regulatory compliance reviews. (A compliance plan is the fund's internal process document that covers conflicts of interest, management of fund assets, internal controls, and so forth.) We believe compliance can be adequately monitored by regulatory compliance reviews, which would be less costly to industry than mandatory external audits.

- In Australia, where the regulatory scheme covers a broad assortment of investment vehicles besides mutual funds, independent representatives are required either on the board of the fund company or through a compliance committee. We have addressed the issue of independent governance in Principle 3. As we explain in our Discussion of that Principle, we believe it has yet to be demonstrated that, in the mutual fund context, the benefit to investors would outweigh the significant related costs.

Principle 7 of the Code and accompanying Guidelines would replace:

- **National Instrument 81-102 *Mutual Funds* (Sections 2.1 – 2.4, 2.6 – 2.9, 2.12 – 2.14, 3.1 and 3.2) and related Companion Policy**

Section 2.1 of this instrument prohibits a mutual fund from investing more than 10% of its net assets in any one issuer, derivative or index participation fund. There are exemptions for index mutual funds, government securities and securities issued by a clearing corporation. Section 2.2 prohibits purchases of 10% or more of an issuer's securities and purchases for the purpose of control. Section 2.3 prohibits the purchase of certain risky and illiquid securities and restricts the investment in others. Section 2.4 prohibits a mutual fund from investing more than 10% of a fund in illiquid assets and from holding more than 15% in illiquid assets for 90 days or more.

Section 2.6 prohibits a number of investment practices affecting liquidity and risk. Sections 2.7, 2.8 and 2.9 establish rules for a mutual fund to trade in derivatives. Sections 2.12 through 2.14 establish rules for securities lending transactions.

We expect that the Guidelines to Principle 7 would address all these issues, making these detailed and prescriptive provisions no longer necessary.

Section 3.1 of the instrument prohibits the filing of a prospectus for a new mutual fund unless the fund company, portfolio manager or related parties have invested at least $150,000 or the fund does not accept subscriptions until at least $500,000 have been received from other investors. Section 3.2 prohibits the distribution of securities of a new fund unless the fund has received the minimum subscription disclosed in the prospectus. To the extent there are special risks associated with new funds that need to be addressed, they can be identified and discussed in the Guidelines to be developed for Principle 7. Therefore, these sections would no longer be necessary.

- **Multilateral Instrument 81-104 *Commodity Pools* (Parts 2 and 3) and related Companion Policy**

Part 2 of this instrument exempts commodity pools from specific provisions in Part 2 of NI 81-102. We would no longer need these exemptions because Principle 7 would replace the relevant provisions of NI 81-102, except one that deals with disclosure. (See Chapter 1 for our Proposals relating to disclosure.)

Part 3, which does not apply in British Columbia, provides different rules for new commodity pools. Under our Proposals, new commodity pools would be treated like other new mutual funds and subject to Principle 7.

- **National Policy 29 *Mutual Funds Investing in Mortgages***

NP 29 regulates mutual funds that invest in mortgages. It sets out a liquidity formula for these funds, prohibits investment in higher-risk mortgages, such as those on raw land or mortgages other than first mortgages, and sets out numerous detailed requirements for these types of funds. Principle 7 would address these issues.

Principle 8 – Valuation

Code and Guidelines

Value the assets in your fund regularly using appropriate and consistent valuation techniques that reflect current market value and in the currency disclosed in your fund's public disclosure record.

It is critical that your fund's assets are capable of valuation and are valued appropriately and consistently at all times. Valuation is crucial because it affects the price clients pay for fund units, the fund's Net Asset Value (NAV), and the redemption price. Your valuation should be made in the disclosed valuation currency, which would usually match the currency in which units are bought and redeemed.

Some assets are difficult to value. Real estate, mortgages and derivatives are particularly problematic as are other illiquid assets. Having a qualified appraiser to value the underlying property can assist in valuing mortgages and real estate. It is also difficult to value securities that are bought off-market or are otherwise illiquid. If a security no longer trades on a marketplace or if trading has been suspended for a long period of time, its valuation should not be based on its last trading price.

To meet your valuation obligation, you should establish valuation criteria and methods as well as other processes to ensure the NAV is calculated regularly and consistently and that asset values reflect current market values. As discussed under Principle 2, you will need to ensure you have qualified people to value the fund's assets, either internally or through outsourcing.

For cash or securities that trade on a market, the valuation is straightforward, as long as the securities are trading, there is an active liquid market, and trading has not been halted, suspended or delisted.

For other assets, you may need to "fair value" the asset. You should establish a process for this, which should include how frequently the asset will be valued and a review procedure. We encourage you to review any IFIC publications, including IFIC Bulletin 23, dealing with fair valuation.

Discussion

Principle 8 of the Code and accompanying Guidelines would replace:

- **National Instrument 81-102 *Mutual Funds* (Sections 2.3, 2.4 and 2.6 re purchasing off-market and Part 13) and related Companion Policy**

See the Discussion under Principle 7 for a description of sections 2.3, 2.4 and 2.6 of this instrument.

While Principle 7 would cover the liquidity and risk issues relating to illiquid assets, the Guidelines to Principle 8 address the difficulty in valuing such assets and suggests using a fair value approach in some circumstances. Similarly, Principle 7 would deal with the risk aspects of purchasing off-market securities, while Principle 8 would cover valuation issues.

Part 13 of NI 81-102 deals with calculating the NAV per security, and covers matters like frequency, currency, restricted securities and derivatives. Principle 8 would require the fund to calculate the NAV on a regular basis using the currency set out in the fund's public disclosure record. The Guidelines would expand NI 81-102 by discussing when a fair valuation approach may be appropriate.

- **Multilateral Instrument 81-104 *Commodity Pools* (Part 7) and related Companion Policy**

Part 7 exempts commodity pools from Part 13 of NI 81-102. These exemptions would no longer be necessary since Principle 8 would replace Part 13.

- **National Policy 29 *Mutual Funds Investing in Mortgages***

NP 29 regulates mutual funds that invest in mortgages. It sets out the acquisition price for mortgages acquired on an arm's length and non-arm's length basis. A number of the prohibitions and detailed requirements were no doubt included because of the difficulty in valuing mortgages. The Guidelines to Principle 8 discuss this issue.

Principle 9 – Compliance systems

Code and Guidelines

1. **Maintain an effective system to ensure compliance with this Code, all applicable regulatory and other legal requirements, your fund's disclosed objectives and strategies, and your own internal policies and procedures.**

You must develop, implement and monitor a written compliance system that satisfies the requirements of the Code. The system you develop should be effective for your particular fund company and its business procedures.

You should consider the risks of non-compliance and establish measures designed to address them. You should list key processes, systems and structures that you will use to ensure that your fund company complies with this Code and other requirements. Your records should include evidence of all compliance monitoring. Among other things, consider if your computer and other systems are secure and can meet operational requirements and whether you have an effective disaster recovery plan. A separate record of related party transactions will help those responsible for governance in your fund discharge their oversight responsibilities.

Consider how best to describe your system in a way that provides useful guidance for your staff.

Perhaps the best way to achieve effective compliance is to have the compliance function in your fund company independent from other functions and have the compliance reporting relationship reflect this. In small fund companies with few employees, the compliance function is unlikely to work effectively unless senior operating management assumes this responsibility.

2. Ensure that your compliance function possesses the technical competence, adequate resources, and experience necessary for the performance of its functions.

An effective system will provide for monitoring compliance with the system. This usually requires:

- a designated individual who is responsible for the compliance function,
- staff, sufficient in number, independence, competence and authority to effectively operate and enforce the system, and
- regular audits of the system's effectiveness.

You should provide sufficient training so that existing and new staff are familiar with your compliance system. You should consider authorizing your compliance personnel to report matters directly to your board of directors or any governance agency, when appropriate.

Discussion

Principle 9 of the Code and the accompanying Guidelines would replace:

- **Act, s. 126 *Report of mutual fund manager***

This section requires a mutual fund company to report to the Commission within 30 days after the end of the month in which various specified related party transactions occur. Principle 9, which would require a fund company to have appropriate compliance systems, would replace this section.

- **Act, s. 129 *Filing in other jurisdictions***

This section allows reporting issuers that are organized under the laws of another jurisdiction to file in BC reports that are required in the other jurisdiction where the reports are substantially similar to those required by Part 15 of the Act. This section would no longer be necessary once we eliminate section 126.

- **Act, s. 130 *Exemptions***

This section allows the Commission to grant exemptions from Part 15 of the Act or the related regulations. It would no longer be necessary because Principles 1, 4 and 9, which would give the fund company discretion as to how to meet its obligations, would replace Part 15.

- **National Instrument 81-102 *Mutual Funds* (Sections 2.10, 2.16, 6.7 and 11.5 and Part 12 and Appendix B-1) and related Companion Policy**

Section 2.10 of this instrument deals with portfolio managers receiving advice from a non-resident sub-adviser on the use of options or standardized futures. In addition to setting out a standard of care for these advisers and sub-advisers, it also requires the portfolio manager to enter into a contract with the sub-adviser.

Section 2.16 requires the agent in a securities lending, repurchase or reverse repurchase transaction to have specified internal controls and requires the fund company to review the agreements and controls annually.

Section 6.7 requires a custodian to review the custodian agreement and the actions of sub-custodians and to advise the mutual fund annually of whether the custodian and sub-custodian are complying with their requirements.

Section 11.5 provides that contractual arrangements with service providers must allow for examination of books and records to monitor compliance with requirements.

Principle 9 would deal with the compliance systems of the fund company. It, and section 5 of Principle 1, would replace all these provisions.

Section 12.1(1) of the instrument requires a fund to report annually on its compliance with the requirements in Parts 9, 10 and 11, dealing with purchases and redemptions of fund units and commingling of cash. The fund's auditor must audit compliance with those Parts to form an opinion on the fund's report. Appendix B-1 sets out the forms of reports for the fund and its auditor.

Principle 9 would require regular monitoring of the fund company's compliance program and would replace all these requirements. In addition, the Commission would conduct compliance reviews of fund companies to monitor their compliance with the Code and other requirements.

- **BC Form 81-903F *Report Required Under Section 126 of the Act***

This is the required form of report under section 126 of the Act for related party transactions. Since the Guidelines to Principle 9 suggest that a list of related party transactions be kept as part of an effective compliance system, we could eliminate this form.

Principle 10 – Client complaints

Code and Guidelines

Create and use adequate procedures for handling client complaints effectively. Disclose complaint procedures to your clients.

You must deal directly with all formal and informal complaints or disputes or refer them to the appropriate person or process, in a timely and forthright manner. You should be fully aware of all applicable processes for dealing with complaints and should disclose to all clients the channels available for pursuing different types of complaints (for example, regarding conduct, service or product performance).

It is good business practice to respond in writing to any client who complains about you or your fund company.

Discussion

Principle 10 of the Code does not replace any existing provisions.

CHAPTER 3
CODE OF CONDUCT: ADVISERS

In Chapter 2, Part 1 of *New Proposals for Securities Regulation*, published in June 2002, we explained the background to the code of conduct approach we propose for registrants. That Chapter also contained a draft Code for investment dealers. You can find a copy of the June paper at www.bcsc.bc.ca/bcproposals.

The following Code parallels the Investment Dealer Code in our June paper in the areas that deal with the adviser-client relationship. However, it differs from the Investment Dealers Code in that it is written with the advisory relationship in mind, and reflects the functions that portfolio managers perform that dealers do not. The Code would apply to all firms registered as portfolio managers and, except for Principle 6 (Compliance systems), to representatives of those firms. The Code would be located in the *Securities Rules*.

We are proposing that the "investment counsel" registration category be discontinued and that those now registered as investment counsel would be registered in the "portfolio manager" category. In this Code we refer to those registered in the new portfolio manager category as "advisers".

The Code is based on the principle that advisers owe a duty to their clients to place the interests of those clients above their own. Advisers would have to adhere to this general principle as well as comply with the Code's specific provisions. Advisers have individual, corporate and institutional clients, including mutual funds. In applying this Code to each type of client relationship, you should consider the particular circumstances. In this Code, "client" includes a prospective client.

The use of derivatives does not avoid the restrictions of this Code. The Code applies both to direct conduct and to conduct effected through transactions that have the same indirect result or economic effect.

Failure to follow the Principles set out in the Code could result in criminal liability, regulatory sanctions and/or civil action for both firms and their representatives.

In addition to this Code, advisers would be subject to other requirements including the *Code of Ethics and Standards of Professional Conduct* of the Association for Investment Management and Research (AIMR), Canadian money laundering and anti-terrorism legislation, and the Criminal Code of Canada. Advisers should also consider the Investment Funds Institute of Canada (IFIC) *Guidelines for a Mutual Fund Manager Code of Ethics*.

The provisions of the Code that would appear in the Rules are in bold face type. The paragraphs that follow each Code provision would appear in the Guidelines.

Principle 1 – Integrity and fairness

Code and Guidelines

1. **Act fairly, honestly and in good faith and in the best interests of your client. Inform your clients of all facts that a reasonable person would consider important to the business relationship.**

2. **Exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.**

You have a duty to your clients to act honestly, in good faith and in their best interests. Examples of conduct that would violate this duty are:

- Front running
- Wash-trading
- High closing
- Pricing illiquid securities artificially
- Delaying client asset transfers unnecessarily or unreasonably
- Failing to disclose cross trading between the adviser and the client

Relationships with clients are based on trust. Each client, therefore, needs to know any information about you and your business, good and bad, that a reasonable client would want to know before entering into or continuing that relationship. You should also keep each client informed about any conditions attached to your registration as well as your relevant employment and regulatory history.

In establishing proper communication procedures, each firm should ensure that its terms of business with a client are set out in adequate detail in a contract. You may want to develop a flexible form of client agreement to enter into with each client.

3. **Comply with all relevant laws and regulations that govern you.**

You must keep informed of the laws that govern your business and you must follow them. Apart from securities laws, these laws could include exchange regulations and federal proceeds of crime and anti-terrorist legislation.

4. **Your conduct must not bring the reputation of the securities market into disrepute. You should take all reasonable steps to determine whether your client's actions threaten the integrity of the securities market.**

You may not turn a blind eye to the actions of your clients.

5. **If your client refuses to comply with regulatory requirements, you must cease to act on behalf of that client.**

You should use all reasonable efforts to ensure that your client understands the relevant regulatory requirements and their implications at all stages of a transaction. If you become aware that your client is not complying with regulatory requirements, you should inform your compliance officer and advise your client to correct the matter. If your client refuses or fails to do so, you must no longer act for that client and you should consider whether to bring the client's activities to the regulators' attention.

6. A firm must not exclude or restrict any duty or liability it may have under this Code.

For example, you cannot use client agreements in your business that purport to exclude the application of this Code or other regulations.

Discussion

Principle 1 of the Code and the accompanying Guidelines would replace:

- **Act, s. 54 *Representation or holding out of registration***
- **Act, s. 55 *Approval of commission or executive director not to be represented***

Sections 54 and 55 prohibit specific misrepresentations (non-registrants holding themselves out as registrants, representations that the Commission has passed on the merits of a security, or the fitness of a registrant). They would be unnecessary because section 50(1)(d) of the Act contains a general prohibition against misrepresentations.

- **Act, s. 128 *Trades by insiders***

This section prohibits a person from using information about the investment program of a portfolio or a managed account to buy or sell securities for the person's benefit. It would be replaced by the requirement in Principle 1 to meet appropriate standards of professional ethics, which would include a prohibition against front running. It is also replaced by the AIMR *Code of Ethics and Standards of Professional Conduct*.

- **Rules, s. 11 *False representation prohibited***

This section says that a person must not use the words "portfolio manager", "investment counsel", "securities adviser", "investment adviser", or any other words in connection with the business of a person, in a way likely to deceive or mislead the public about the proficiency and qualifications of the person selling the securities. We could eliminate section 11 because section 50(1)(d) of the Act prohibits misrepresentations and because Section 1 of Principle 1 would require you to be honest and inform your client of all facts that a reasonable person would consider important.

- **Rules, s.14 *Fair dealing with clients***

This section requires an adviser to deal fairly, honestly and in good faith with the adviser's clients. Section 1 of Principle 1 would cover all of these obligations.

- **Rules, s. 50 *Information about registrant available on client's request***

This section specifies certain information that a client can receive on request. Principles 1 and 6 would impose a somewhat higher standard. They would require advisers to inform clients about everything that is relevant to the business relationship, both at the time of opening the account and on an ongoing basis when there are significant changes in that information.

- **Rules, s. 52 *Change in ownership or sale of account***

This section requires that if there has been a material change in the ownership or control of a portfolio manager, or a portfolio manager proposes to sell or assign a client's account, the portfolio manager must provide immediately to each of its BC clients a written explanation of the change and inform them of their right to close or transfer the account. The obligation to keep clients informed in Section 1 of Principle 1 would replace this provision.

Principle 2 – Confidentiality

Code and Guidelines

Hold in strict confidence all confidential information acquired in the course of your relationship with clients, unless the client consents to the disclosure, the disclosure is required by law, or the client appears to be engaging in activity that threatens the integrity of the securities market.

In a client-adviser relationship, you will receive information about your client's financial circumstances. Such financial information is confidential. Receiving such information places you in a position of trust and responsibility and it is unethical to betray this trust. If information is disclosed, the damage to the client is the same whether or not the disclosure was intentional.

You may disclose your client's confidential information in three situations; you should explain these situations to the client at the beginning of your relationship.

First, you may disclose information if you get the client's consent, preferably in writing. Having the client sign a "blanket" consent statement allowing the general release of confidential information over an indefinite period will not be sufficient.

Second, you must disclose if you are required to do so by law. Legal requirements include legally enforceable requests for information from the Commission or other regulators and provisions of Canadian money laundering and anti-terrorist legislation.

Third, you may disclose your client's confidential information to the extent necessary to help regulators deal with situations where the client is engaging in activity that threatens the integrity of the markets, as contemplated in Section 4 of Principle 1.

Discussion

Principle 2 of the Code and the accompanying Guidelines would replace**:**

- **National Instrument 33-102 *Regulation of Certain Registrant Activities* (Part 3)**

Part 3 of this instrument prohibits an adviser from disclosing client information to third parties except as required by law or if the client consents.

Principle 3 – Proficiency

Code and Guidelines

Maintain the proficiency, skill and diligence necessary to properly advise and serve your clients.

The Commission will set the minimum proficiency standards for advisers entering the securities industry. However, in a rapidly changing financial marketplace, you must keep abreast of changes in products, regulations and other factors that will affect your ability to provide high standards of client service. Education, especially continuing education, is a necessary component of business skill and the responsibility for maintaining proficiency falls on the adviser.

Firms should establish adequate re-qualification requirements for advisers who have been out of the securities industry long enough to affect their proficiency. Firms may want to consider the following when making proficiency decisions:

- The length of time an adviser has been out of the financial industry
- The adviser's relevant experience during his or her unlicenced time
- The adviser's educational background
- Any industry continuing education courses completed by the adviser while not licenced

Firms should also consider developing policies to deal with advisers employed in other occupations both inside and outside of the securities industry.

Discussion

Principle 3 of the Code and the accompanying Guidelines would replace:

- **Rules, s. 62 *Rewriting industry exams***

This section requires a registrant who has been inactive for three or more years to rewrite the relevant exams. Since we think firms should be allowed to determine the appropriate policies in this area, we could eliminate section 62.

Principle 4 – Know your client and suitability

Code and Guidelines

1. **Take reasonable steps to learn and keep current your knowledge of the essential facts about the identity, reputation and financial circumstances of each client.**

2. **Determine the general investment needs and objectives of the client, the client's risk tolerance, the appropriateness of the recommendations you make to that client, and the suitability of a proposed purchase or sale for that client's portfolio.**

3. **Recommend only those purchases or sales that are suitable for the investment needs and objectives of that client's portfolio. If a purchase or sale initiated by a client is**

not suitable, advise the client of the unsuitability before executing the proposed transaction.

4. **Provide investors with the information necessary to make informed investment decisions.**

Principle 4 combines what have traditionally been referred to as the “know your client” and “suitability” rules. These rules apply to all advice that advisers give to clients, whether or not the advice relates to exempt market securities.

Section 1 of Principle 4, known as the “know your client” rule, requires that you understand on an ongoing basis the client’s identity, background, financial position and character so you can fulfill your role as a “gatekeeper” to the market. If your client is not an individual, knowing your client means knowing the individuals that control the client, its business and its financial circumstances.

Sections 2 and 3 of Principle 4 refer to “suitability” and require that you ensure that your client’s portfolio remains suitable, having regard to the client’s investment needs and objectives, the client’s risk tolerance, and other relevant facts about the client that you know or ought reasonably to know.

You should make every effort to give your clients objective and impartial information about their financial needs, and advise them of their various options. You should identify and explain to the client all negative aspects of proposed investments or portfolios, including the risks and costs of your recommendations. Of particular importance are any costs that reduce the net return on the portfolio to the investor. You should also have a reasonable basis for the recommendations you make to your client.

In addition to clearly describing the product or service for the client and the ways that the transaction will fulfill the client’s needs, you should disclose product information, such as important assumptions underlying any illustrations or examples provided to the client, and the fact that actual results may differ significantly from those shown. You should avoid using examples or illustrations that you know, or ought to know, are based on unusual results or on a period that generated much better than normally anticipated performance.

Where, with the agreement of the client, a firm has pooled the client’s funds with those of others with a view to making common discretionary management decisions for all the clients involved, the firm must take reasonable steps to ensure that a discretionary transaction is suitable for the portfolio as a whole, based on the stated investment objectives of the portfolio.

Advisers are reminded that individual suitability requirements for clients are still applicable for purchases of securities sold under registration exemptions and in a “pooled fund” discretionary trading environment. You should ensure that there is consistency between the client’s objectives and the investment objectives of the fund. As well, if your client intends to invest using borrowed money, you should discuss the risks of leveraged investing.

Make sure you use plain language to prepare the information you give your clients and that you present that information in a way that is easy to read and understand. Examples of “plain language” techniques include:

- Short sentences

- Definite, everyday language
- Using the active voice
- Organizing the document in clear, concise sections, paragraphs and sentences
- Avoiding legal or business jargon and boilerplate wording

Discussion

Principle 4 of the Code and the accompanying Guidelines would replace:

- **Rules, s. 35 *Statement to be provided to prospective client***
- **BC Form 91-903F *Risk Disclosure Statement (Exchange Contracts)***

This section states that when opening an account for a client, the adviser must give the client a written statement "in the required form". The form required under this section is BC Form 91-903F *Risk Disclosure Statement (Exchange Contracts)*. We would no longer mandate this form of disclosure. Section 4 of Principle 4 requires you to provide investors with information necessary to make informed investment decisions. It would be up to the adviser to determine whether it was necessary to inform a given client of these particular risks. Therefore, we could eliminate section 35.

- **Rules, s. 48 *Know your client and suitability rules***

This section contains the existing "know your client" and "suitability" rules.

- **Rules, s. 51 *Separate supervision of accounts and pooling***

Under this section, an adviser must supervise each client account separately and distinctly. We could eliminate this section because separate supervision of accounts would be part of the suitability of the client's overall portfolio, which is covered by Principle 4.

- **National Instrument 33-102 *Regulation of Certain Registrant Activities* (Parts 2 and 6)**

Part 2 of this instrument requires delivery of a written disclosure statement to the client about the risks of leveraged investing and Part 6 requires delivery of a written disclosure statement to clients dealing with a registrant in offices in financial institutions. These provisions would not be needed because they would be covered by the general obligation in Principle 4 to disclose all risks related to a proposed investment.

Principle 5 – Conflict of interest

Code and Guidelines

1. **Resolve all significant conflicts of interest in favour of the client using fair, objective and transparent criteria. If there is a conflict of interest between clients, use fair, objective and transparent criteria to resolve those conflicts. In both cases, apply the criteria consistently.**

This Principle makes it clear that the client's interests always come first. (This should be interpreted in the context of reasonable commercial practice – an extreme interpretation would suggest that you could not charge a client a fee.) The best way to ensure that the client's interests are put first is to have appropriate procedures in place to ensure that all conflicts of interest between the firm or adviser and the client are resolved in favour of the client and to have a system that effectively monitors and enforces compliance with those procedures. These procedures should cover conflicts of interest arising in the context of advising, managing discretionary accounts and managing the investment portfolio of a mutual fund. The onus of showing that the adviser has acted in the best interests of the client is on the adviser.

It could be difficult to show that you have acted in a client's best interests if the client is required or expected to deal with a particular financial institution in connection with the advice you provide, or to pay for advice to obtain other financial products or services ("tied selling").

Sometimes the conflict of interest is not between the adviser or firm and client, but between clients. For example, an adviser sometimes has to decide how to allocate limited investment opportunities among clients. Again, these situations are best resolved if the adviser has appropriate procedures in place to deal with them, and a system to monitor and enforce compliance with those procedures.

Inside information

Sometimes an adviser will receive material, non-public information (inside information). If this happens, an adviser must ensure that it is handled properly.

Securities legislation prohibits anyone from acting on inside information. Advisers must not buy or sell, or participate in a decision to buy or sell, a security for any portfolio while possessing inside information about the security or the issuer. This is a complete prohibition and applies to any portfolio in which the adviser plays any role in making investment decisions or exercises any investment discretion, or over which the adviser has direct or indirect control, regardless of whether the adviser has a personal, economic or ownership interest.

Advisers may disclose material non-public information only if it is in the necessary course of business. Otherwise, it would breach the tipping provisions in securities legislation. Firms should have specific procedures for dealing with inside information.

You may want to create information barriers within your firm to "wall off" those who are routinely exposed to inside information from those who are not. If you restrict the knowledge to those who learn of it – and those who have a need to know it – those who do not know of it remain free to act with respect to the securities involved, whether for the portfolios under their management or for their own personal accounts. Without information barriers, the knowledge of one part of the organization could be imputed to the entire organization.

Corporate boards

If an adviser serves on a board of directors or trustees, several conflicts could arise, including conflicting fiduciary duties to the company and a portfolio, possible receipt of inside information, and conflicting demands on the adviser's time. Advisers should seek permission from their firms to serve on a board of directors of a public issuer or a privately held company that raises capital in the exempt market. Firms should consider having policies for board participation, which would identify the circumstances in which the activity would be in the best interests of a portfolio.

2. Develop conflict of interest procedures and disclose them to the client.

Conflicts of interest arise frequently in the securities industry and can be unique to each firm. Some conflicts can be avoided through adopting proper procedures while other conflicts are unavoidable in the context of normal business practice and should be managed as they occur. Firms must develop conflict of interest procedures that work for their specific business. You should communicate the conflict procedures to each client at the beginning of your business relationship in a way that the client can easily understand.

To avoid situations where the personal interests of advisers conflict or appear to conflict with their duties to their clients, firms should set rules for trading in personal accounts. This Code does not prohibit advisers from making responsible personal investments. However, an adviser must not use information about the firm's investment recommendations or portfolio transactions for the adviser's personal profit.

Here are examples of effective policies that some industry firms have developed regarding personal trading:

- Requiring advisers to surrender short-term trading profits
- Imposing delay periods between trading a security in a client portfolio and trading the same security in the adviser's personal accounts
- Imposing delay periods between the release of a research report and trading the same issuer in the adviser's personal account

3. Disclose promptly to the client any information that a reasonable client would consider important in determining your ability to provide objective service or advice.

Conflicts that you cannot avoid should be managed appropriately. You must fully disclose to your clients all conflicts of interest and all potential conflicts of interest that you know, or ought to know, about. Advisors should disclose security ownership as part of the initial and ongoing communication with clients. You have an obligation to ensure that your clients are aware of and understand these conflicts. Even when you believe that your actions are not affected by the conflict, you must adequately address even an appearance of conflict.

All commissions and fees should be transparent to a client in any proposal the adviser puts forth. Once the business relationship begins, you should disclose fees and commissions to clients on an ongoing basis.

Section 3 of Principle 5 will usually require advisers to disclose to their clients the compensation they receive that is related to the work they do for the client or to their relationship with the client. This would include fees received or paid for client referrals, sharing compensation (commission splitting), contingency fees, and any compensation incentives you receive in connection with the client or the client's business. You must disclose this information before the client has to decide about the transaction in question.

"Soft dollar" arrangements – arrangements where brokers accept commissions as payment for goods or services other than order execution or related services – create the perception that the portfolio may be bearing higher execution costs than would otherwise be the case.

Discussion

Principle 5 of the Code and the accompanying Guidelines would replace:

- **Act, s. 121 *Investments of mutual funds***
- **Act, s. 122 *Indirect investments***
- **Act, s. 123 *Relieving orders***

Section 121 prohibits an adviser from entering into certain transactions of a mutual fund, including loans and investments to or in related parties or substantial security holders. This section could be eliminated because Section 1 of Principle 5 would require all significant conflicts to be resolved in favour of the client.

Section 122 prohibits advisers from entering into a contract or other arrangement that results in liability for an investment prohibited by section 121. Section 123 permits the Commission to grant exemptions from sections 121 and 122. Sections 122 and 123 would be unnecessary once we eliminate section 121.

- **Act, s. 124 *Fees on investment for mutual fund***

This section prohibits an adviser from investing for a mutual fund where a related person will receive a fee or other compensation unless the relevant contract is disclosed in the fund's simplified prospectus or the Commission grants exemptive relief to allow the investment. This section could be eliminated because Section 1 of Principle 5 would require all significant conflicts to be resolved in favour of the client and Section 3 of Principle 5 would require disclosure of all fees and compensation.

- **Act, s. 127 *Restrictions on transactions with responsible persons***

This section prohibits an adviser from causing a mutual fund to: (i) invest in any issuer in which the adviser is a partner, officer or director unless this fact has been disclosed to the mutual fund security holders, (ii) buy or sell the securities of any issuer from or to the account of an adviser, or (iii) make a loan to an adviser. This section could be eliminated because Principle 5 would require advisers to resolve all conflicts in favour of the client and to disclose all conflict situations.

- **Rules, s. 53 *Disclosure of referral fees and commission splitting***
- **Rules, s. 54 *No contingent fees without client's consent***

These sections require advisers to disclose to the client any referral fees and commission splitting, and prohibit registrants from charging contingency fees without the client's prior consent. Principle 5 would deal with these situations and we discuss them as examples in the accompanying Guidelines. We would not specifically require prior consent to contingency fee arrangements, but Section 3 of Principle 5 says that advisers must provide the information that section requires promptly. We would expect advisers to disclose contingency fees on the opening of an account that was established on a contingency basis, or on a trade-by-trade basis if the account was not set up on that basis generally. Either way, the client would have the information before trading.

- **Rules, s. 75 *Interpretation***

This section contains the definitions for Division 11 of Part 5 of the Rules, *Registrants' Conflicts of Interest*. Since Principle 5 would replace all of Division 11, we could eliminate this provision.

- **Rules, s. 77 *Conflict of interest rules statement***
- **BC Form 33-907F *Conflict of Interest Rules Statement***
- **BC Form 33-908F *Statement and Undertaking***

Section 77 of the Rules requires advisers to give specified disclosure about conflicts of interest to the client at the time the account is opened. (BCF 33-907F prescribes the disclosure.) It also exempts advisers from making that disclosure if the conflict scenarios that the disclosure covers do not apply. To use the exemption, the registrant must file another form (BCF 33-908F) with the Commission.

Principle 5 would replace section 77 and both forms. Advisers would have to resolve conflicts in favour of the client. The Guidelines suggest that advisers put procedures in place to ensure this happens, and provide for transparency by disclosure to the client. We think this would be a more effective regime than the existing one because it would ensure that the client gets information directly relevant to the procedures used by his or her registrant.

- **Rules, s. 81 *Limitations on advising***
- **Rules, s. 82 *Limitations on the exercise of discretion***
- **Rules, s. 83 *Limitations on recommendations***

These sections require specified conflict of interest disclosure in certain advising and recommending situations, and when an adviser is managing a discretionary account. The disclosure obligation in Section 3 of Principle 5 would replace them.

- **Rules, s. 85 *Exceptions***

This section provides exemptions from Division 11 of Part 5 of the Rules. Since Principle 5 would replace Division 11, we could eliminate this section.

- **National Instrument 33-102 *Regulation of Certain Registrant Activities* (Section 3.2 and Parts 4 and 5)**

Section 3.2 of this instrument prohibits an adviser from requiring a client to disclose confidential information as a condition of supplying products or services to that client unless the client requests a product or service for which the method of settlement requires disclosure of client information. Part 4 states that no adviser may require a person to settle a transaction with the adviser through that person's account at a Canadian financial institution as a condition, or on terms that would appear to a reasonable person to be a condition, of supplying a product or service, unless this method of settlement is reasonably necessary to provide the specific product or service that the person has requested. Part 5 states that no person may require another to invest in particular securities as a condition of supplying products or services.

Principles 1 and 5 would replace all these provisions. It is difficult to see how a registrant that was a party to these sorts of arrangements would be acting in the client's best interests, avoiding conflicts with the client, or resolving conflicts in the client's favour.

- **National Instrument 81-105 *Mutual Fund Sales Practices* (Sections 2.1, 7.1(3), 7.2 – 7.4 and Parts 3, 5 and 6) and related Companion Policy**

This instrument prohibits certain sales practices and compensation arrangements for mutual fund industry participants. It was intended to set minimum standards of conduct for these industry participants when distributing mutual fund securities, and to ensure that investors' interests were put first. It was designed to minimize conflicts between the interests of industry participants and those of investors.

Section 2.1 prohibits an adviser acting on behalf of a fund company from paying money or giving benefits to dealers or their representatives, except in accordance with the instrument. Part 3 does not allow rates for commissions and trailing commissions to vary based on the amount of a fund the dealer has sold, the amount the dealer's clients hold, or the time of year when commission is earned on sales of the fund units. Part 5 deals with marketing and educational practices, including paying to send dealer representatives to industry conferences. Part 6 prohibits reciprocal commissions. Sections 7.1(3), 7.2 and 7.3 prohibit commission rebates, financial assistance and charitable donations. Section 7.4 prohibits tied selling.

The portions of the instrument that apply to advisers and their representatives are no longer necessary because Section 1 of Principle 5 would require advisers to put their clients' interests before their own and Section 3 of Principle 5 would require the investor to be informed about conflict information, including all aspects of compensation and fees. We believe these Principles would be more likely to focus advisers on the balance between effective and fair compensation and the interests of the portfolios they manage.

While Principle 5 would replace only those parts of NI 81-105 relating to advisers, the separate Codes for Fund Companies and Mutual Fund Dealers (see Chapters 2 and 4) would deal with the remaining issues in the instrument. Therefore, we could eliminate the entire instrument.

- **BC Instrument 81-504 *Transactions Between Mutual Funds and Responsible Persons Relating to Certain Debt Securities, Mortgages, and Equity Securities***

This instrument provides relief from the self dealing prohibitions in section 127 of the Act for certain transactions between related parties. Since Principle 5 replaces section 127, we could eliminate this instrument.

Principle 6 – Compliance systems

Code and Guidelines

1. Maintain an effective system to ensure compliance with this Code, all applicable regulatory and other legal requirements, and your own internal policies and procedures.

You must develop, implement and monitor a written compliance system that satisfies the requirements of the Code. The system you develop should be effective for your particular firm and its business procedures. You should consider AIMR guidelines as a guide to good practice when constructing your compliance system.

You should consider the risks of non-compliance and establish measures designed to address them. You should list key processes, systems and structures that you will use to ensure that your firm complies with this Code and other requirements. Your records should include evidence of all compliance monitoring. Among other things, consider if your computer and other systems are secure and can meet operational requirements and whether you have an effective disaster recovery plan.

If you run your business from multiple locations, you should consider whether to designate one individual who will have compliance responsibility in some or all of those locations. Perhaps the best way to achieve effective compliance is to have the compliance function in your firm independent from other functions and have the compliance reporting relationship reflect this. In small firms with few employees, the compliance function is unlikely to work effectively unless senior operating management assumes this responsibility.

2. Ensure that your compliance function possesses the technical competence, adequate resources, and experience necessary for the performance of its functions.

An effective system will provide for monitoring compliance with the system. This usually requires:

- a designated individual who is responsible for the compliance function,
- staff, sufficient in number, independence, competence and authority to effectively operate and enforce the system, and
- regular audits of the system's effectiveness.

You should provide sufficient training so that existing and new staff are familiar with your compliance system. You should consider authorizing your compliance personnel to report matters directly to your board of directors, when appropriate.

3. Ensure that all of your staff members who engage in advising activities are appropriately qualified and supervised.

You are responsible for all advising activities by your representatives and therefore you must not only hire people with the appropriate qualifications but also supervise them. Those acting in supervisory positions should have sufficient experience to do so and should also be fully familiar with the firm's compliance system.

4. Provide clients with all the information that a reasonable client would consider important respecting all transactions that you conduct on the client's behalf on an ongoing basis.

You should send the client all relevant information relating to advising, based on the mandate with the client. This would likely take the form of regular statements that keep clients informed about the status of their portfolio and about the activity in the portfolio since the last statement. This includes details of changes to the portfolio, any consideration the client pays in connection with those changes, and any information about conflicts (see Principle 5). The objective is to ensure the client has information on a current basis that is reasonable in the circumstances. This would normally mean quarterly, although you and your client may agree to more or less frequent reporting. It would also include anything the client will need to know to prepare and file income tax returns relating to the client's accounts with the adviser.

You should also keep each client informed about your relevant employment and regulatory history.

5. Notify the Commission immediately of any significant change in the information relating to the registration, and of the hiring or termination (including reasons), of any adviser.

The information you provided when you registered is important to the Commission's assessment of your fitness as a registrant and to the Commission's ability to maintain contact with you. Therefore, any change in this information is significant and you must disclose it to the Commission.

You should fully disclose the circumstances of any termination, especially if your representative breached any provisions of the Code and this played any part in the termination. When asked by the regulators about a possible breach of a relevant regulation (whether committed by you or by your client), you should respond cooperatively and truthfully.

Discussion

Principle 6 of the Code and the accompanying Guidelines would replace:

- **Act, s. 42 *Notice of change***

This section sets out when advisers must notify the Commission of changes to their registration. This section will be repealed with the future introduction of the National Registration Database (NRD). Sections 4.3 to 4.6 of the proposed multi-lateral instrument on NRD (MI 31-102) set out when a firm must notify the NRD administrator of any changes to the information form initially submitted. Principle 6 would broaden the requirement to include any changes to information previously provided to the Commission. In addition, we have incorporated some of the circumstances described in section 42 into the Guidelines to Principles 1 and 6 to clarify that information about changes to an adviser's registration could be important to clients as well.

- **Act, s. 126 *Report of mutual fund manager***

This section requires advisers to file a report about certain transactions for each fund that they provide services or advice for. This section could be eliminated because Principle 6 would require appropriate compliance systems.

- **Act, s. 129 *Filing in other jurisdictions***

This section allows reporting issuers that are organized under the laws of another jurisdiction to file in BC reports that are required in the other jurisdiction where the reports are substantially similar to those required under Part 15 of the Act. This section would no longer be necessary once we eliminate section 126.

- **Act, s. 130 *Exemptions***

This section allows the Commission to grant exemptions from Part 15 of the Act or the related regulations. It would no longer be necessary because Principles 1 and 6, which would give advisers discretion as to how to meet their obligations, would replace Part 15.

- **Rules, s. 38(7) *Statement of account***

This section states that unless a client has expressly directed otherwise, an adviser must send to each client at least once every three months a statement of the client's portfolio. Section 4 of Principle 6 would replace this section.

- **Rules, s. 44 *Registrant's business procedures***

This section states that an adviser must establish and apply written prudent business procedures for dealing with clients in compliance with the Act and the regulations.

- **Rules, s. 47 *Responsibility for opening new accounts and supervising***
- **Rules, s. 65 *Designated compliance officer required***
- **Rules, s. 66 *Branch manager required***

Section 47 states that an adviser must designate a compliance officer and a branch manager. This would be replaced by Principle 6, which would provide firms more flexibility in developing compliance systems that work for their particular business but would still suggest that a designated individual be responsible for compliance.

Section 65 states that an adviser must designate at least one individual as compliance officer, and section 66 requires an adviser that has a branch office to employ a branch manager who is approved by the executive director and who ensures that the branch complies with the Act and regulations. This would be dealt with in the Guidelines about appropriate supervisory systems in Principle 6.

- **Rules, s. 68 *Notice under section 42 of the Act***

This section requires a registered dealer, underwriter, adviser or salesperson to file the notice required under section 42 of the Act not more than five business days after the change to which the notice relates. This section would no longer be needed once we replace section 42 (see above).

- **Rules, s. 73 *Notice of ownership***
- **Rules, s. 74 *Notice of diversification***

Under section 73, an underwriter, adviser or registered dealer that knows or has reason to believe that a person is about to or has acquired beneficial ownership or control of 10% or more of any class or series of the outstanding voting securities of that registrant must file written notice of that fact with the regulator. Under section 74, an underwriter, adviser or registered dealer that intends to carry on any business other than that of a dealer, underwriter or adviser, must file written notice of that intention on or before the 30th day before the registrant begins carrying on the other business. The executive director can object to the diversification of the registrant’s business and, after giving the registrant an opportunity to be heard, may decline to allow the diversification if it is thought to be in the public interest. Section 5 of Principle 6 would replace these sections.

Principle 7 – Client complaints

Code and Guidelines

Create and use adequate procedures for handling client complaints effectively. Disclose complaint procedures to your clients.

You must deal directly with all formal and informal complaints or disputes or refer them to the appropriate person or process, in a timely and forthright manner. You should be fully aware of all applicable processes for dealing with complaints and should disclose to all clients the channels available for pursuing different types of complaints (for example, regarding conduct, service or product performance).

It is good business practice to respond in writing to any client who complains about you or your firm.

Discussion

Principle 7 of the Code does not replace any existing provisions.

Principle 8 – Management of public mutual fund assets

Code and Guidelines

If you are managing public mutual fund assets, comply with Principles 7 and 8 of the Code of Conduct for Fund Companies.

Discussion

Principle 8 of the Code does not replace any existing provisions.

CHAPTER 4
CODE OF CONDUCT: MUTUAL FUND DEALERS

In Chapter 2, Part 1 of *New Proposals for Securities Regulation*, published in June 2002, we explained the background to the code of conduct approach we propose for registrants. That Chapter also contained a draft Code for investment dealers. You can find a copy of the June paper at www.bcsc.bc.ca/bcproposals.

The following Code, which has many similarities to the one in our June paper, would be for mutual fund dealers. It would apply to all firms registered as mutual fund dealers and, except for Principle 6 (Compliance systems), to representatives of those firms. The Code would be located in the *Securities Rules*.

The use of derivatives does not avoid the restrictions of this Code. The Code applies both to direct conduct and to conduct effected through transactions that have the same indirect result or economic effect.

Failure to follow the Principles set out in the Code could result in criminal liability, regulatory sanctions and/or civil action for both dealers and their representatives.

The provisions of the Code that would appear in the Rules are in bold face type. The paragraphs that follow each Code provision would appear in the Guidelines.

In this Code, "client" includes a prospective client.

Principle 1 – Integrity and fairness

Code and Guidelines

1. **Act fairly, honestly and in good faith and in the best interests of your client. Inform your clients of all facts that a reasonable person would consider important to the business relationship.**

2. **Exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.**

You have a duty to your clients to act honestly and fairly in keeping with business ethics standards. You will violate this duty if you engage in conduct involving dishonesty, fraud, deceit or misrepresentation. Examples of this conduct are churning accounts and failing to be forthright with your client about your sales charges or commissions or any limitation on your ability to service your client's investment needs.

Relationships with clients are based on trust. Each client, therefore, needs to know any information about you and your business, good and bad, that a reasonable client would want to know before entering into or continuing that relationship. You should tell your client that you are authorized to trade only in mutual funds and securities sold under registration and prospectus exemptions (known as “exempt market products”). You should also keep each client informed about any conditions attached to your registration as well as your relevant employment and regulatory history.

Soliciting business from persons at their home must be done within the bounds of fair dealing. You should do so only during reasonable times and you should respect an individual’s request not to be contacted again. Under securities law, the person making the call must not make statements that could be viewed as soliciting a trade in a security unless the person is registered. Firms may also want to establish employee policies for unsolicited communications with prospective clients to avoid violations of the communication abuse rules under federal competition law.

Other examples of breaches of the fair dealing provision include failing to transfer-out client account holdings on a timely basis and delaying the execution of a client requested trade.

3. Comply with all relevant laws and regulations that govern you.

You must keep informed of the laws that govern your business and you must follow them. Apart from securities laws, these laws could include exchange regulations, federal proceeds of crime and anti-terrorist legislation, and aspects of federal competition law.

4. Your conduct must not bring the reputation of the securities market into disrepute. You should take all reasonable steps to determine whether your client’s actions threaten the integrity of the securities market.

You may not turn a blind eye to the actions of your clients.

5. If your client refuses to comply with regulatory requirements, you must cease to act on behalf of that client.

You should use all reasonable efforts to ensure that your client understands the relevant regulatory requirements and their implications at all stages of a transaction. If you become aware that your client is not complying with regulatory requirements, you should inform your compliance officer and advise your client to correct the matter. If your client refuses or fails to do so, you must no longer act for that client and you should consider whether to bring the client’s activities to the regulators’ attention.

6. A firm must not exclude or restrict any duty or liability it may have under this Code.

For example, you cannot use client agreements in your business that purport to exclude the application of this Code or other regulations.

Discussion

Principle 1 of the Code and the accompanying Guidelines would replace:

- **Act, s. 49 *Calling at or telephoning residence***
- **BC Instrument 33-506 *Exemption from Cold Calling Restrictions for Registered Dealers***

Section 49 prohibits calling at or telephoning residences, subject to some exceptions. It could be eliminated as communication abuses are covered by federal competition law. BCI 33-506, which exempts certain registrants from the cold calling restrictions in the Act, would be unnecessary once section 49 is repealed.

- **Act, s. 50(1)(c) *Representations prohibited***
- **Act, s. 54 *Representation or holding out of registration***
- **Act, s. 55 *Approval of commission or executive director not to be represented***
- **BC Notice 47-701 *Blanket Permission under Section 50(1)(c) of the Securities Act***

Section 50(1)(c) of the Act prohibits a person from representing that a security will be listed unless the person first obtains the permission of the executive director. (BCN 47-701 provides blanket permission.) This section could be eliminated because section 50(1)(d) of the Act contains a general prohibition against misrepresentations. It would be a misrepresentation to state that an issuer was expected to list its shares on an exchange if there is no reasonable basis for that statement, such as knowledge that the issuer had applied for a listing and that the application was being considered by the relevant exchange.

Sections 54 and 55 prohibit specific misrepresentations (non-registrants holding themselves out as registrants, representations that the Commission has passed on the merits of a security, or the fitness of a registrant). Again, we could eliminate these provisions because section 50(1)(d) prohibits misrepresentations generally.

BCN 47-701 would be unnecessary once section 50(1)(c) is repealed.

- **Rules, s. 11 *False representation prohibited***

This section says that a person must not use the words “portfolio manager”, “investment counsel”, “securities adviser”, “investment adviser”, or any other words in connection with the business of a person, in a way likely to deceive or mislead the public about the proficiency and qualifications of the person selling the securities. We could eliminate section 11 because section 50(1)(d) of the Act prohibits misrepresentations and because Section 1 of Principle 1 would require you to be honest and inform your client of all facts that a reasonable person would consider important.

- **Rules, s. 14 *Fair dealing with clients***

This section requires a registrant to deal fairly, honestly and in good faith with the registrant’s clients. Section 1 of Principle 1 would cover all of these obligations.

- **Rules, s. 50 *Information about registrant available on client’s request***

This section specifies certain information that a client can receive on request. Principles 1 and 6 would impose a somewhat higher standard. They would require registrants to inform clients about everything that is relevant to the business relationship, both at the time of opening the account and on an ongoing basis when there are significant changes in that information.

Principle 2 – Confidentiality

Code and Guidelines

Hold in strict confidence all confidential information acquired in the course of your relationship with clients, unless the client consents to the disclosure, the disclosure is required by law, or the client appears to be engaging in activity that threatens the integrity of the securities market.

In the course of your employment, you will receive information about your client's financial circumstances. Such financial information is confidential. Receiving such information places you in a position of trust and responsibility and it is unethical to betray this trust. If information is disclosed, the damage to the client is the same whether or not the disclosure was intentional.

You may disclose your client's confidential information in three situations; you should explain these situations to the client at the beginning of your relationship.

First, you may disclose information if you get the client's consent, preferably in writing. Having the client sign a "blanket" consent statement allowing the general release of confidential information over an indefinite period will not be sufficient.

Second, you must disclose if you are required to do so by law. Legal requirements include legally enforceable requests for information from the Commission or your self-regulatory organization (SRO) and provisions of Canadian money laundering and anti-terrorist legislation.

Third, you may disclose your client's confidential information to the extent necessary to help regulators deal with situations where the client is engaging in activity that threatens the integrity of the markets, as contemplated in Section 4 of Principle 1.

Discussion

Principle 2 of the Code and the accompanying Guidelines would replace:

- **National Instrument 33-102 *Regulation of Certain Registrant Activities* (Part 3)**

Part 3 of this instrument prohibits a registrant from disclosing client information to third parties except as required by law or the rules of an SRO, or if the client consents.

Principle 3 – Proficiency

Code and Guidelines

Maintain the proficiency, skill and diligence necessary to properly advise and serve your clients.

The Commission or your SRO will set the minimum proficiency standards for entering the securities industry. However, in a rapidly changing financial marketplace, you must keep abreast of changes in products, regulations and other factors that will affect your ability to provide high standards of client service. Education, especially continuing education, is a necessary component of business skill and the responsibility for maintaining proficiency falls on both firms and salespersons.

The proficiency requirement applies to all products sold by firms and salespersons. Where products other than mutual funds are sold, firms should ensure that the persons who do due diligence on those products, the persons who sell them, and their supervisors, have qualifications relevant to the products being sold.

Firms should establish adequate re-qualification requirements for salespersons who have been out of the securities industry long enough to affect their proficiency. Firms may want to consider the following when making proficiency decisions:

- The length of time a salesperson has been out of the financial industry
- The salesperson's relevant experience during his or her unlicenced time
- The salesperson's educational background
- Any industry continuing education courses completed by the salesperson while not licenced

Firms should also consider developing policies to deal with salespersons employed in other occupations both inside and outside of the securities industry.

Discussion

Principle 3 of the Code and the accompanying Guidelines would replace:

- **Rules, s. 62 *Rewriting industry exams***

This section requires a registrant who has been inactive for three or more years to rewrite the relevant exams. Since we think firms should be allowed to determine the appropriate policies in this area, we could eliminate section 62.

- **Rules, s. 63 *Salesperson employed other than full-time***

This section prevents salespersons from working outside of the securities industry unless they obtain the executive director's consent. Section 63 was enacted for two reasons. First, it is designed to prevent a salesperson from becoming involved in conflict of interest situations through outside employment. Second, it is thought to ensure the salesperson's proficiency in the securities industry by focusing that person's full attention on securities-related employment. Principle 3 would address the proficiency concern. The conflict of interest point is discussed under Principle 5. Therefore, we could eliminate section 63.

Principle 4 – Know your client and suitability

Code and Guidelines

1. **Take reasonable steps to learn and keep current your knowledge of the essential facts about the identity, reputation and financial circumstances of each client.**

2. **Determine the general investment needs and objectives of the client, the client's risk tolerance, the appropriateness of the recommendations you make to that client, and the suitability of a proposed purchase or sale for that client.**

3. **Recommend only those purchases or sales that are suitable for the investment needs and objectives of that client. If a purchase or sale initiated by a client is not suitable, advise the client of the unsuitability before executing the proposed transaction.**

4. **Provide clients with the information necessary to make informed investment decisions.**

Principle 4 combines what have traditionally been referred to as the "know your client" and "suitability" rules. They apply to all trades that registrants make on behalf of clients, whether or not the securities are sold under registration exemptions.

Section 1 of Principle 4, known as the "know your client" rule, requires that you understand on an ongoing basis the client's identity, background, financial position and character so you can fulfill your role as a "gatekeeper" to the market. If your client is not an individual, knowing your client means knowing the individuals that control the client, its business and its financial circumstances.

Sections 2 and 3 of Principle 4 refer to "suitability" and require that you determine what is suitable when recommending or selling products or services, having regard to the client's investment needs and objectives, the client's risk tolerance, and other relevant facts about the client that you know or ought reasonably to know.

You should make every effort to give your clients objective and impartial information about their financial needs, and advise them of their various options. You should identify and explain to the client all negative aspects of proposed investments, including the risks and costs of your recommendations. Of particular importance are any costs that reduce the net return on any fund you are recommending, such as mutual fund management expense ratios. You should also have a reasonable basis for the recommendations you make to your client.

In addition to clearly describing the product or service for the client and the ways that the transaction will fulfill the client's needs, you should disclose product information, such as important assumptions underlying any illustrations or examples provided to the client, and the fact that actual results may differ significantly from those shown. You should avoid using examples or illustrations that you know, or ought to know, are based on unusual results or on a period that generated much better than normally anticipated performance.

To give a client additional information about a mutual fund, you can refer the client to the relevant continuous disclosure record.

The suitability obligation also requires you to advise your client on factors other than the features of the investment itself. For example, if your client intends to invest using borrowed money, you should discuss the risks of leveraged investing. The suitability obligation also applies to purchases of securities sold under registration exemptions.

Make sure you use plain language to prepare the information you give your clients and that you present that information in a way that is easy to read and understand. Examples of "plain language" techniques include:

- Short sentences
- Definite, everyday language
- Using the active voice
- Organizing the document in clear, concise sections, paragraphs and sentences
- Avoiding legal or business jargon and boilerplate wording

Discussion

Principle 4 of the Code and the accompanying Guidelines would replace:

- **Rules, s. 48 *Know your client and suitability rules***

This section contains the existing "know your client" and "suitability" rules.

- **National Instrument 33-102 *Regulation of Certain Registrant Activities* (Parts 2 and 6)**

Part 2 of this instrument requires delivery of a written disclosure statement to the client about the risks of leveraged investing and Part 6 requires delivery of a written disclosure statement to clients dealing with a registrant in offices in financial institutions. These provisions would not be needed because they would be covered by the general obligation in Principle 4 to disclose all risks related to a proposed investment.

Principle 5 – Conflict of interest

Code and Guidelines

1. **Resolve all significant conflicts of interest in favour of the client using fair, objective and transparent criteria. If there is a conflict of interest between clients, use fair, objective and transparent criteria to resolve those conflicts. In both cases, apply the criteria consistently.**

This Principle makes it clear that the client's interests always come first. (This should be interpreted in the context of reasonable commercial practice – an extreme interpretation would suggest that you could not charge a client a fee.) The best way to ensure that the client's interest are put first is to have appropriate procedures in place to ensure that all conflicts of interest between the firm or salesperson and the client are resolved in favour of the client and to have a system that effectively monitors and enforces compliance with those procedures. These procedures should cover conflicts of interest arising in the context of trading, advising and making recommendations. The onus of showing that the firm or salesperson has acted in the best interests of the client is on the firm or salesperson.

It could be difficult to show that you have acted in a client's best interests if the client is required or expected to deal with a particular financial institution in connection with the services you provide, or to pay for advice to obtain other financial products or services ("tied selling").

Sometimes the conflict of interest is not between the registrant and client, but between clients. For example, a registrant sometimes has to decide how to allocate limited investment opportunities among clients. Again, these situations are best resolved if the firm has appropriate procedures in place to deal with them, and a system to monitor and enforce compliance with those procedures.

2. Develop conflict of interest procedures and disclose them to the client.

Conflicts of interest arise frequently in the securities industry and can be unique to each firm. Some conflicts can be avoided through adopting proper procedures while other conflicts are unavoidable in the context of normal business practice and should be managed as they occur. Firms must develop conflict of interest procedures that work for their specific business. You should communicate your conflict procedures to each client at the beginning of your business relationship in a way that the client can easily understand.

"Blanket" disclosure about routine compensation arrangements in general is appropriate so long as you disclose changes to those arrangements promptly. However, in other cases (for example, referral fees), disclosure should be made on a case-by-case basis so that the client can consider the information in the context of any decision the client needs to make in the circumstances giving rise to the compensation.

3. Disclose promptly to the client any information that a reasonable client would consider important in determining your ability to provide objective service or advice.

Conflicts that you cannot avoid should be managed appropriately. You must fully disclose to your clients all conflicts of interest and all potential conflicts of interest that you know, or ought to know, about. Certain conflicts are inherent in the relationship between you and your clients, such as any remuneration you receive for selling mutual fund units to a client and any recommendations you make when selling proprietary products or services of your firm or an affiliated company.

You have an obligation to ensure that your clients are aware of and understand these conflicts. Even when you believe that your actions are not affected by the conflict, you must adequately address even an appearance of conflict.

One of the most important areas for full disclosure is anything to do with compensation you receive that relates to the work you do for the client or to your relationship with the client. You must disclose fees received or paid for client referrals, sharing compensation (commission splitting), contingency fees, and any compensation incentives you receive in connection with the client or the client's business (for example, trailer fees). You must disclose this information before the client has to decide about the transaction in question.

For example, sometimes several products would be suitable for a client but one product will entitle you to a significantly higher commission or a benefit such as a trip. You should disclose this to your client when you discuss the merits of the product.

Discussion

Principle 5 of the Code and the accompanying Guidelines would replace:

- **Rules, s. 53 *Disclosure of referral fees and commission splitting***
- **Rules, s. 54 *No contingent fees without client's consent***

These sections require registrants to disclose to the client any referral fees and commission splitting, and prohibit registrants from charging contingency fees without the client's prior consent. Principle 5 would deal with these situations and we discuss them as examples in the accompanying Guidelines. We would not specifically require prior consent to contingency fee arrangements, but Section 3 of Principle 5 says that registrants must provide the information that section requires promptly. We would expect registrants to disclose contingency fees on the opening of an account that was established on a contingency basis, or on a trade-by-trade basis if the account was not set up on that basis generally. Either way, the client would have the information before trading.

- **Rules, s. 63 *Salesperson employed other than full-time***

This section prevents salespersons from working outside of the securities industry unless they obtain the executive director's consent. Section 63 was enacted for two reasons. First, it is designed to prevent a salesperson from becoming involved in conflict of interest situations through outside employment. Second, it is thought to ensure the salesperson's proficiency in the securities industry by focusing that person's full attention on securities-related employment. We do not think it would be necessary to retain this restriction since the conflict of interest provisions in Principle 5 would require that registrants put their clients' interests before their own. The proficiency concern is dealt with in Principle 3.

- **Rules, s. 75 *Interpretation***

This section contains the definitions for Division 11 of Part 5 of the Rules, *Registrants' Conflicts of Interest*. Since Principle 5 would replace all of Division 11, we could eliminate this provision.

- **Rules, s. 77 *Conflict of interest rules statement***
- **BC Form 33-907F *Conflict of Interest Rules Statement***
- **BC Form 33-908F *Statement and Undertaking***

Section 77 of the Rules requires registrants to give specified disclosure about conflicts of interest to the client at the time the account is opened. (BCF 33-907F prescribes the disclosure.) It also exempts registrants from making that disclosure if the conflict scenarios that the disclosure covers do not apply. To use the exemption, the registrant must file another form (BCF 33-908F) with the Commission.

Principle 5 would replace section 77 and both forms. Registrants would have to resolve conflicts in favour of the client. The Guidelines suggest that registrants put procedures in place to ensure this happens, and provide for transparency by disclosure to the client. We think this would be a more effective regime than the existing one because it would ensure that the client gets information directly relevant to the procedures used by his or her registrant.

- **Rules, s. 79** ***Limitations on trading***
- **Rules, s. 81** ***Limitations on advising***
- **Rules, s. 83** ***Limitations on recommendations***

These sections require specified conflict of interest disclosure in certain trading, advising and recommending situations. The disclosure obligation in Section 3 of Principle 5 would replace them.

- **Rules, s. 80** ***Confirmation and reporting of transactions***

This section requires specified disclosure in related-party situations to be included in the confirmation notice. The provision is no longer necessary since Section 3 of Principle 5 would require the investor to be informed about conflict information.

- **Rules, s. 85** ***Exceptions***

This section provides exemptions from Division 11 of Part 5 of the Rules. Since Principle 5 would replace Division 11, we could eliminate this section.

- **National Instrument 33-102** ***Regulation of Certain Registrant Activities*** **(Section 3.2 and Parts 4 and 5)**

Section 3.2 of this instrument prohibits a registrant from requiring a client to disclose confidential information as a condition of supplying products or services to that client unless the client requests a product or service for which the method of settlement requires disclosure of client information. Part 4 states that no registrant may require a client to settle an account through the client's financial institution as a condition of supplying products or services. Part 5 states that no person may require another to invest in particular securities as a condition of supplying products or services.

Principles 1 and 5 would replace all of these provisions. It is difficult to see how a registrant that was a party to these sorts of arrangements would be acting in the client's best interests, avoiding conflicts with the client, or resolving conflicts in the client's favour.

- **National Instrument 81-105** ***Mutual Fund Sales Practices*** **(Sections 6.1(5), 6.2 and 8.2(3) – (5) and Parts 2, 3, 4, 5 and 7) and related Companion Policy**

This instrument prohibits certain sales practices and compensation arrangements for mutual fund industry participants. It was intended to set minimum standards of conduct for these industry participants when distributing mutual fund securities, and to ensure that investors' interests were put first. It was designed to minimize conflicts between the interests of industry participants and those of investors.

Section 2.1 prohibits a fund company from paying money or giving benefits to dealers or their representatives, except in accordance with the instrument.

Section 2.2(1) states that a dealer or its representative may not ask for or take any benefit from a mutual fund for any expense the dealer or representative incurs.

Sections 2.2(2) and 2.3 allow dealers and representatives to accept benefits in specified, limited circumstances.

Part 3 does not allow rates for commissions and trailing commissions to vary based on the amount of a fund the dealer has sold, the amount the dealer's clients hold, or the time of year when commission is earned on sales of the fund units.

Under section 4.1(1), a dealer may not give its representatives an incentive to recommend the mutual funds of one fund family over the funds of another. Section 4.1(2) states that the compensation a dealer pays to its representatives may reflect commissions the dealer receives from members of the organizations of mutual funds (e.g. fund managers, fund principal distributors, etc.), on certain conditions.

Under section 4.2(1), a person that is a principal distributor of a mutual fund and a dealer of another may not provide an incentive for any of its representatives to recommend a fund of which it is a principal distributor over a fund of which it is a dealer. Section 4.2(2) states that the compensation a principal distributor pays to its representatives may reflect commissions the principal distributor receives from members of the organizations of mutual funds, on certain conditions.

Part 5 deals with marketing and educational practices, including paying to send dealer representatives to industry conferences.

Under section 6.1(5), a dealer may not solicit or execute portfolio transactions of a fund as inducement or reward for selling the fund's securities or maintaining particular levels of the fund's securities in client accounts. Section 6.2 states that a dealer may not execute a portfolio transaction unless it has been directed to the dealer through the dealer's institutional representative.

Section 7.1(1) states that a dealer or its representative may pay a fee or commission payable by a client on a redemption occurring when the client buys securities of a mutual fund in a different fund family, on certain conditions, including providing disclosure to the client and receiving the client's written consent. Subsection (2) prescribes what the disclosure must contain, including reasonable estimates of the fee or commission and the redemption charges.

Sections 7.1(3), 7.2 and 7.3 prohibit commission rebates, financial assistance and charitable donations.

Section 7.4 prohibits tied selling.

Section 8.2 requires disclosure about, among other things, any equity interest a member of the organization of a mutual fund holds in a dealer, and any interest a dealer or its representative holds in the member. Subsection (3) requires a dealer to give a client written disclosure about these equity interests when the client buys an interest in the relevant mutual fund. Under section 8.2(4), the dealer cannot complete the trade until the client has received the disclosure and consents in writing to the trade. Under section 8.2(5), if the client has received the disclosure in connection with an earlier trade and the information has not changed, the dealer does not have to provide the disclosure again or get the client's consent.

The portions of the instrument that apply to mutual fund dealers and their representatives would no longer be necessary because Section 1 of Principle 5 would require registrants to put their clients' interests before their own and Section 3 of Principle 5 would require the investor to be informed about conflict information. We do not think that anything else would be necessary to ensure that investors' interests and the integrity of the mutual fund industry are foremost in the minds of mutual fund dealers and their representatives.

While Principle 5 would replace only those parts of NI 81-105 relating to mutual fund dealers and their representatives, the separate Codes for Fund Companies and Advisers (see Chapters 2 and 3) would deal with the remaining issues in the instrument. Therefore, we could eliminate the entire instrument.

Principle 6 – Compliance systems

Code and Guidelines

1. Maintain an effective system to ensure compliance with this Code, all applicable regulatory and other legal requirements, and your own internal policies and procedures.

You must develop, implement and monitor a written compliance system that satisfies the requirements of the Code. The system you develop should be effective for your particular firm and its business procedures.

You should consider the risks of non-compliance and establish measures designed to address them. You should list key processes, systems and structures that you will use to ensure that your firm complies with this Code and other requirements. Your records should include evidence of all compliance monitoring. Among other things, consider if your computer and other systems are secure and can meet operational requirements and whether you have an effective disaster recovery plan.

If you run your business from multiple locations, you should consider whether to designate one individual who will have compliance responsibility in some or all of those locations. Perhaps the best way to achieve effective compliance is to have the compliance function in your firm independent from other functions and have the compliance reporting relationship reflect this. In small firms with few employees, the compliance function is unlikely to work effectively unless senior operating management assumes this responsibility.

2. Ensure that your compliance function possesses the technical competence, adequate resources, and experience necessary for the performance of its functions.

An effective system will provide for monitoring compliance with the system. This usually requires:

- a designated individual who is responsible for the compliance function,
- staff, sufficient in number, independence, competence and authority to effectively operate and enforce the system, and
- regular audits of the system's effectiveness.

You should provide sufficient training so that existing and new staff are familiar with your compliance system. You should consider authorizing your compliance personnel to report matters directly to your board of directors, when appropriate.

3. **Ensure that all of your staff members who engage in trading activities are appropriately qualified and supervised.**

You are responsible for all trading activities by your representatives and therefore you must not only hire people with the appropriate qualifications but also supervise them. Those acting in supervisory positions should have sufficient experience to do so and should also be fully familiar with the firm's compliance system.

4. **Provide clients with all the information that a reasonable client would consider important respecting all transactions that you conduct on the client's behalf at the time of the transaction and on an ongoing basis.**

You should promptly send the client all relevant information relating to a trade, having regard to the type of security being traded. This includes the particulars of the trade, any consideration the client pays in connection with the trade, and any information about conflicts of interest that apply to the trade (see Principle 5). It would also include anything the client will need to know to prepare and file income tax returns relating to the client's accounts with the registrant.

You should send your clients statements that keep them informed about the status of their accounts and about the activity in those accounts since the last statement. The objective is to ensure the client has information on a current basis that is reasonable in the circumstances. This would normally mean monthly, however, less frequent reporting may be reasonable in some circumstances (for example, if the volume and frequency of trading in the account is low, or if the client requests less frequent reporting).

You should also keep each client informed about your relevant employment and regulatory history.

5. **Notify the Commission immediately of any significant change in the information relating to the registration, and of the hiring or termination (including reasons), of any registered individual.**

The information you provided when you registered is important to the Commission's assessment of your fitness as a registrant and to the Commission's ability to maintain contact with you. Therefore, any change in this information is significant and you must disclose it to the Commission.

You should fully disclose the circumstances of any termination, especially if your representative breached any provisions of the Code and this played any part in the termination. When asked by the regulators about a possible breach of a relevant regulation (whether committed by you or by your client), you should respond cooperatively and truthfully.

In the case of dually licensed individuals, it is the firm's obligation to inform the Commission of breaches by those individuals of other regulatory requirements because this goes to the person's character and suitability to be employed in the securities industry. For example, if the individual is licensed to sell insurance products and is disciplined for violating an insurance-related rule, you must inform the Commission of that violation.

Discussion

Principle 6 of the Code and the accompanying Guidelines would replace:

- **Act, s. 42 *Notice of change***

This section sets out when registrants must notify the Commission of changes to their registration. This section will be repealed with the future introduction of the National Registration Database (NRD). Sections 4.3 to 4.6 of the proposed multi-lateral instrument on NRD (MI 31-102) set out when a firm must notify the NRD administrator of any changes to the information form initially submitted. Principle 6 would broaden the requirement to include any changes to information previously provided to the Commission. In addition, we have incorporated some of the circumstances described in section 42 into the Guidelines to Principles 1 and 6 to clarify that information about changes to a registrant's registration could be important to clients as well.

- **Rules, s. 36 *Confirmation of purchase or sale***
- **Rules, s. 37 *Confirmation of purchase or sale respecting mutual funds***
- **Rules, s. 38 *Statement of account***

Sections 36 and 37 require different confirmation notices for different types of securities. The confirmation for mutual fund securities varies depending if the purchase or sale is under a contractual plan.

Section 38 specifies how often a registrant must provide statements of account and sets out what the statements must contain.

The Mutual Fund Dealers Association of Canada (MFDA) specifies the form and delivery requirements relating to trade confirmations and statements of account. Therefore, there is no need for the Commission to mandate detailed requirements in these areas. Even if the MFDA did not have the rules it does, we would not impose the detailed requirements that we currently do.

Under Principle 6, a firm would have to provide the information that is important to the reasonable client having regard to the type of security being traded. Therefore, it would be unnecessary to prescribe different forms of confirmations for different types of securities with variations for certain mutual fund securities. Principle 6 would also cover confirmations for future new investment products that are not specifically contemplated under existing rules.

As for account statements, Principle 6 would let firms tailor their account reporting practices to the level of activity in the account and the client's wishes.

- **Rules, s. 44 *Registrant's business procedures***
- **Rules, s. 46 *Investment dealer's and mutual fund dealer's guidelines***

Section 44 states that a registrant must establish and apply written prudent business procedures for dealing with clients in compliance with the Act and the regulations. Section 46 states that a mutual fund dealer will comply with section 44 if it follows the bylaws, rules or other regulatory instruments or policies relating to dealing with clients established by a recognized SRO. Principle 6 would replace these sections.

- **Rules, s. 47 *Responsibility for opening new accounts and supervising***
- **Rules, s. 65 *Designated compliance officer required***
- **Rules, s. 66 *Branch manager required***

Section 47 states that a registrant must designate a compliance officer and a branch manager. This would be replaced by Principle 6, which would provide firms more flexibility in developing compliance systems that work for their particular business but would still suggest that a designated individual be responsible for compliance.

Section 65 states that a dealer, underwriter or adviser must designate at least one individual as compliance officer, and section 66 requires a dealer or adviser that has a branch office to employ a branch manager who is approved by the executive director and who ensures that the branch complies with the Act and regulations. This would be dealt with in the Guidelines about appropriate supervisory systems in Principle 6.

- **Rules, s. 68 *Notice under section 42 of the Act***

This section requires a registered dealer, underwriter, adviser or salesperson to file the notice required under section 42 of the Act not more than five business days after the change to which the notice relates. This section would no longer be needed once we replace section 42 (see above).

- **Rules, s. 73 *Notice of ownership***
- **Rules, s. 74 *Notice of diversification***

Under section 73, an underwriter, adviser or registered dealer that knows or has reason to believe that a person is about to or has acquired beneficial ownership or control of 10% or more of any class or series of the outstanding voting securities of that registrant must file written notice of that fact with the regulator. Under section 74, an underwriter, adviser or registered dealer that intends to carry on any business other than that of a dealer, underwriter or adviser, must file written notice of that intention on or before the 30th day before the registrant begins carrying on the other business. The executive director can object to the diversification of the registrant's business and, after giving the registrant an opportunity to be heard, may decline to allow the diversification if it is thought to be in the public interest. Section 5 of Principle 6 would replace these sections.

Principle 7 – Client complaints

Code and Guidelines

Create and use adequate procedures for handling client complaints effectively. Disclose complaint procedures to your clients.

You must deal directly with all formal and informal complaints or disputes or refer them to the appropriate person or process, in a timely and forthright manner. You should be fully aware of all applicable processes for dealing with complaints and should disclose to all clients the channels available for pursuing different types of complaints (for example, regarding conduct, service or product performance).

Some registrants are also registered to do business in other sectors, such as insurance. In this case, you must inform clients of the differing complaint resolution mechanisms for each sector in which you do business and how the clients can use those mechanisms. For those persons who are also insurance licenced, you will be subject to applicable insurance regulations in this area.

It is good business practice to document all complaints made against you for potential review by regulators and to respond in writing to any client who complains about you or your firm.

Discussion

Principle 7 of the Code does not replace any existing provisions.

CHAPTER 5
CURRENT REGULATORY PROVISIONS
WHAT STAYS, WHAT GOES

What the Proposals Replace

This table sets out the current provisions governing mutual funds and mutual fund industry participants that our Proposals would replace or eliminate:

Current provision	Replaced by
Act, s. 42 *Notice of change*	**Mutual Fund Dealers Code and Advisers Code, Principle 6 (Compliance systems)**
Act, s. 49 *Calling at or telephoning residence* Act, s. 50(1)(c) *Representations prohibited*	**Mutual Fund Dealers Code, Principle 1 (Integrity and fairness)**
Act, s. 54 *Representation or holding out of registration* Act, s. 55 *Approval of commission or executive director not to be represented*	**Mutual Fund Dealers Code and Advisers Code, Principle 1 (Integrity and fairness)**
Act, s. 61 *Prospectus required* Act, s. 63 *Contents of prospectus*	**Streamlined AIF and optional point of sale document (Chapter 1, Offering mutual funds to the public)**
Act, s. 64 *Executive director's discretion* Act, s. 65 *Receipt for prospectus*	**Similar sections for streamlined AIF (Chapter 1, Offering mutual funds to the public)**
Act, s. 66 *Amendment to preliminary prospectus* Act, s. 67 *Amendment to prospectus*	**Streamlined AIF and optional point of sale document (Chapter 1, Offering mutual funds to the public)**
Act, s. 68 *Certificate of issuer*	**Chapter 1, Continuous disclosure**
Act, s. 70(2) *Lapse of prospectus* Act, s. 71(1) *Distribution of securities may be continued*	**Not replaced as no prospectus**
Act, s. 120 *Definitions and interpretation* Act, s. 121 *Investments of mutual funds* Act, s. 122 *Indirect investment* Act, s. 123 *Relieving orders* Act, s. 124 *Fees on investment for mutual fund*	**Advisers Code, Principle 5 (Conflict of interest) and Fund Companies Code, Principle 4 (Conflict of interest)**

Current provision	Replaced by
Act, s. 125 *Standard of care for management of mutual fund*	**Fund Companies Code, Principle 1 (Standard of care and integrity)**
Act, s. 126 *Report of mutual fund manager*	**Advisers Code, Principle 6 (Compliance systems) and Fund Companies Code, Principle 9 (Compliance systems)**
Act, s. 127 *Restrictions on transactions with responsible person*	**Advisers Code, Principle 5 (Conflict of interest) and Fund Companies Code, Principle 4 (Conflict of interest)**
Act, s. 128 *Trades by insiders*	**Advisers Code, Principle 1 (Integrity and fairness) and Fund Companies Code, Principle 1 (Standard of care and integrity)**
Act, s. 129 *Filing in other jurisdiction* Act, s. 130 *Exemptions*	**Advisers Code, Principle 6 (Compliance systems) and Fund Companies Code, Principle 9 (Compliance systems)**
Rules, s.11 *False representation prohibited* Rules, s.14 *Fair dealing with clients*	**Mutual Fund Dealers Code and Advisers Code, Principle 1 (Integrity and fairness)**
Rules, s. 35 *Statement to be provided to prospective client*	**Advisers Code, Principle 4 (Know your client and suitability) and Principle 6 (Compliance systems)**
Rules, s. 36 *Confirmation of purchase or sale* Rules, s. 37 *Confirmation of purchase or sale respecting mutual funds*	**Mutual Fund Dealers Code, Principle 6 (Compliance systems)**
Rules, s. 38 *Statement of account* Rules, s. 44 *Registrant's business procedures*	**Mutual Fund Dealers Code and Advisers Code, Principle 6 (Compliance systems)**
Rules, s. 46 *Investment dealer's and mutual fund dealer's guidelines*	**Mutual Fund Dealers Code, Principle 6 (Compliance systems)**
Rules, s. 47 *Responsibility for opening new accounts and supervising*	**Mutual Fund Dealers Code and Advisers Code, Principle 6 (Compliance systems)**
Rules, s. 48 *Know your client and suitability rules*	**Mutual Fund Dealers Code and Advisers Code, Principle 4 (Know your client and suitability)**
Rules, s. 50 *Information about registrant available on client's request*	**Mutual Fund Dealers Code and Advisers Code, Principle 1 (Integrity and fairness)**

Current provision	Replaced by
Rules, s. 51 *Separate supervision of accounts and pooling*	**Advisers Code, Principle 4 (Know your client and suitability) and Principle 6 (Compliance systems)**
Rules, s. 52 *Change in ownership or sale of account*	**Advisers Code, Principle 1 (Integrity and fairness)**
Rules, s. 53 *Disclosure of referral fees and commission splitting* Rules, s. 54 *No contingent fees without client's consent*	**Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest)**
Rules, s. 62 *Rewriting industry exams*	**Mutual Fund Dealers Code and Advisers Code, Principle 3 (Proficiency)**
Rules, s. 63 *Salesperson employed other than full-time*	**Mutual Fund Dealers Code, Principle 3 (Proficiency) and Principle 5 (Conflict of interest)**
Rules, s. 65 *Designated compliance officer required* Rules, s. 66 *Branch manager required*	**Mutual Fund Dealers Code and Advisers Code, Principle 6 (Compliance systems)**
Rules, s. 68 *Notice under section 42 of the Act* Rules, s. 73 *Notice of ownership* Rules, s. 74 *Notice of diversification*	**Mutual Fund Dealers Code and Advisers Code, Principle 6 (Compliance systems)**
Rules, s. 75 *Interpretation* Rules, s. 77 *Conflict of interest rules statement*	**Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest)**
Rules, s. 79 *Limitations on trading* Rules, s. 80 *Confirmation and reporting of transactions*	**Mutual Fund Dealers Code, Principle 5 (Conflict of interest)**
Rules, s. 81 *Limitations on advising*	**Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest)**
Rules, s. 82 *Limitations on the exercise of discretion*	**Advisers Code, Principle 5 (Conflict of interest)**
Rules, s. 83 *Limitations on recommendations* Rules, s. 85 *Exceptions*	**Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest)**
Rules, s. 95 *Variation of requirements* Rules, s. 97 *Disclosure called for by prospectus form*	**Not replaced as no prospectus**

Current provision	Replaced by
Rules, s. 98.1 *Alternative certificate of mutual fund* Rules, s. 98.2 *Alternative certificate of non-redeemable investment fund or mutual fund* Rules, s. 98.3 *Certificate of manager* Rules, s. 98.4 *Certificate of promoter* Rules, s. 98.5 *Certificate of principal distributor*	**Chapter 1, Continuous disclosure**
Rules, s. 106 *Written consent of professional to be named* Rules, s. 108 *Further consents* Rules, s. 113 *Financial statements – prospectus – mutual fund* Rules, s. 120 *Refusal to issue a receipt for a prospectus*	**Similar sections for the streamlined AIF**
Rules, s. 121 *Lapse date* Rules, s. 122 *Distribution after lapse date* Rules, s. 124 *Extension of time* Rules, s. 125 *Purchaser's cancellation right* Rules, s. 126 *Time limit for cancellation of trade*	**Not replaced as no prospectus**
Rules, s. 144 *Interim financial statements* Rules, s. 145 *Annual financial statements* Rules, s. 146 *Change in ending date of financial year* Rules, s. 147 *Additional requirements – mutual funds* Rules, s. 148 *Omission of statement of portfolio transactions* Rules, s. 149 *Delivery of financial statements to security holders*	**Similar sections containing the consequential amendments proposed under NI 81-106**
BC Form 33-907F *Conflict of Interest Rules Statement* BC Form 33-908F *Statement and Undertaking*	**Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest)**
BC Form 81-902F *Information Required in Prospectus of a Mutual Fund*	**Streamlined AIF and optional point of sale document (Chapter 1, Offering mutual funds to the public)**
BC Form 81-903F *Report Required under Section 126 of the Act*	**Fund Companies Code, Principle 9 (Compliance systems)**
BC Form 91-903F *Risk Disclosure Statement (Exchange Contracts)*	**Advisers Code, Principle 4 (Know your client and suitability)**
BCI 33-506 *Exemption from Cold Calling Restrictions for Registered Dealers*	**Mutual Fund Dealers Code, Principle 1 (Integrity and fairness)**
BCI 45-505 *Alternative Reporting Requirements for Exempt Distributions of Securities of Eligible Pooled Funds*	**Concept of restricted mutual fund (Chapter 1, Restricted mutual funds)**

Current provision	Replaced by
BC Notice 47-701 *Blanket Permission under Section 50(1)(c) of the Securities Act*	**Mutual Fund Dealers Code, Principle 1 (Integrity and fairness)**
BCI 81-503 *First Renewal Prospectus Filed by Mutual Fund under NI 81-101*	**Not replaced as no prospectus**
BCI 81-504 *Transactions Between Mutual Funds and Responsible Persons Relating to Certain Debt Securities, Mortgages, and Equity Securities*	**Advisers Code, Principle 5 (Conflict of interest) and Fund Companies Code, Principle 4 (Conflict of interest)**
National Instrument 33-102 *Regulation of Certain Registrant Activities*	**Various parts are discussed below**
NI 33-102, Part 2 *Disclosure*	**Mutual Fund Dealers Code and Advisers Code, Principle 4 (Know your client and suitability)**
NI 33-102, Part 3 *Disclosure of confidential retail client information*	**Mutual Fund Dealers Code and Advisers Code, Principle 2 (Confidentiality)**
NI 33-102, Section 3.2 *Prohibition to require consent as a condition*	**Also Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest)**
NI 33-102, Part 4 *Settling securities transactions* NI 33-102, Part 5 *Tied selling*	**Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest)**
NI 33-102, Part 6 *Distribution of securities in a financial institution*	**Mutual Fund Dealers Code and Advisers Code, Principle 4 (Know your client and suitability)**
National Instrument 81-101 *Mutual Fund Prospectus Disclosure*	**Streamlined AIF and optional point of sale document (Chapter 1, Offering mutual funds to the public)**
National Instrument 81-102 *Mutual Funds*	**Various parts are discussed below**
NI 81-102, Section 2.1 *Concentration restriction* NI 81-102, Section 2.2 *Control restrictions*	**Fund Companies Code, Principle 7 (Liquidity and risk management)**
NI 81-102, Section 2.3 *Restrictions concerning types of investments* NI 81-102, Section 2.4 *Restrictions concerning illiquid assets*	**Fund Companies Code, Principle 7 (Liquidity and risk management) and Principle 8 (Valuation)**

Current provision	Replaced by
NI 81-102, Section 2.5 *Investments in other mutual funds*	**Fund Companies Code, Principle 4 (Conflict of interest)**
NI 81-102, Section 2.6 *Investment practices*	**Fund Companies Code, Principle 7 (Liquidity and risk management) and Principle 8 (Valuation)**
NI 81-102, Section 2.7 *Transactions in specified derivatives* NI 81-102, Section 2.8 *Transactions in specified derivatives* NI 81-102, Section 2.9 *Transactions in specified derivatives*	**Fund Companies Code, Principle 7 (Liquidity and risk management)**
NI 81-102, Section 2.10 *Adviser requirements*	**Fund Companies Code, Principle 1 (Standard of care and integrity), Principle 4 (Conflict of interest) and Principle 9 (Compliance systems)**
NI 81-102, Section 2.11 *Commencement of use of specified derivatives by a mutual fund*	**Similar but simplified requirements in continuous disclosure provisions**
NI 81-102, Section 2.12 *Securities loans* NI 81-102, Section 2.13 *Repurchase transactions* NI 81-102, Section 2.14 *Reverse repurchase transactions*	**Fund Companies Code, Principle 7 (Liquidity and risk management)**
NI 81-102, Section 2.15 *Agent for securities lending, repurchase and reverse repurchase transactions*	**Fund Companies Code, Principle 1 (Standard of care and integrity) and Principle 4 (Conflict of interest)**
NI 81-102, Section 2.16 *Controls and records*	**Fund Companies Code, Principle 9 (Compliance systems)**
NI 81-102, Section 2.17 *Commencement of securities lending, repurchase and reverse repurchase transactions by a mutual fund*	**Similar but simplified requirements in continuous disclosure provisions**
NI 81-102, Section 3.1 *Initial investment in a new mutual fund* NI 81-102, Section 3.2 *Prohibition against distribution*	**Fund Companies Code, Principle 7 (Liquidity and risk management)**

Current provision	Replaced by
NI 81-102, Section 3.3 *Prohibition against reimbursement of organization costs*	**Fund Companies Code, Principle 4 (Conflict of interest)**
NI 81-102, Part 4 *Conflicts of interest*	**Fund Companies Code, Principle 4 (Conflict of interest)**
NI 81-102, Section 4.4 *Liability and indemnification*	**Advisers Code, Principle 1 (Standard of care and integrity)**
NI 81-102, Section 6.6 *Standard of care*	**Fund Companies Code, Principle 1 (Standard of care and integrity) and Principle 4 (Conflict of interest)**
NI 81-102, Section 6.7 *Review and compliance reports*	**Fund Companies Code, Principle 9 (Compliance systems)**
NI 81-102, Part 7 *Incentive fees*	**Fund Companies Code, Principle 4 (Conflict of interest)**
NI 81-102, Part 8 *Contractual plans*	**Fund Companies Code, Principle 1 (Standard of care and integrity)**
NI 81-102, Part 9 *Sale of securities of a mutual fund*	**Fund Companies Code, Principle 5 (Dealings with clients)**
NI 81-102, Section 11.5 *Right of inspection*	**Fund Companies Code, Principle 9 (Compliance systems)**
NI 81-102, Part 12 *Compliance reports*	**Fund Companies Code, Principle 9 (Compliance systems)**
NI 81-102, Part 13 *Calculation of net asset value per security*	**Fund Companies Code, Principle 8 (Valuation)**
NI 81-102, Part 17 *Financial statement requirements*	**Similar requirements proposed in NI 81-106**
NI 81-102, Part 18 *Securityholder records*	**Fund Companies Code, Principle 5 (Dealings with clients)**
Multilateral Instrument 81-104 *Commodity Pools*	**Various parts are discussed below**

Current provision	Replaced by
MI 81-104, Part 2 *Investment restrictions and practices* NI 81-104, Part 3 *New Commodity pools*	**Fund Companies Code, Principle 7 (Liquidity and risk management)**
MI 81-104, Part 5 *Incentive fees*	**Fund Companies Code, Principle 4 (Conflict of interest)**
MI 81-104, Part 7 *Calculation of net asset value*	**Fund Companies Code, Principle 8 (Valuation)**
MI 81-104, Part 8 *Continuous disclosure – financial statements*	**Similar sections in financial statement requirements**
MI 81-104, Part 9 *Prospectus disclosure*	**Similar section for streamlined AIF**
National Instrument 81-105 *Mutual fund sales practices*	**Various parts are discussed below**
NI 81-105, Part 2 *General*	**Mutual Fund Dealers Code, Principle 5 (Conflict of interest)**
NI 81-105, Section 2.1 *Restriction on payments or provision of benefits*	**Also Advisers Code, Principle 5 (Conflict of interest) and Fund Companies Code, Principle 4 (Conflict of interest**)
NI 81-105, Part 3 *Permitted compensation*	**Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest) and Fund Companies Code, Principle 4 (Conflict of interest)**
NI 81-105, Part 4 *Internal dealer incentive practices*	**Mutual Fund Dealers Code, Principle 5 (Conflict of interest)**
NI 81-105, Part 5 *Marketing and educational practices*	**Mutual Fund Dealers Code and Advisers Code, Principle 5 (Conflict of interest) and Fund Companies Code, Principle 4 (Conflict of interest)**
NI 81-105, Part 6 *Portfolio transactions*	**Advisers Code, Principle 5 (Conflict of interest) and Fund Companies Code, Principle 4 (Conflict of interest)**
NI 81-105, Section 6.1(5) *Portfolio transactions* NI 81-105, Section 6.2 *Obligations of participating dealers executing portfolio transactions*	**Also Mutual Fund Dealers Code, Principle 5 (Conflict of interest)**

Current provision	Replaced by
NI 81-105, Part 7 *Other sales practices*	**Mutual Fund Dealers Code, Principle 5 (Conflict of interest)**
NI 81-105, Section 7.1(3) *Commission rebates* NI 81-105, Section 7.2 *Financial Assistance* NI 81-105, Section 7.3 *Charitable donations* NI 81-105, Section 7.4 *Tied selling*	**Also Advisers Code, Principle 5 (Conflict of interest) and Fund Companies Code, Principle 4 (Conflict of interest)**
NI 81-105, Section 8.1 *Disclosure of sales practices* NI 81-105, Section 8.2(1) - (2) *Disclosure of equity interests*	**Similar but simplified requirements for streamlined AIF**
NI 81-105, Sections 8.2(3) - (5) *Disclosure of equity interests*	**Mutual Fund Dealers Code, Principle 5 (Conflict of interest)**
NI 81-105, Section 8.3 *Disclosure requirements if no prospectus or simplified prospectus*	**Fund Companies Code, Principle 4 (Conflict of interest)**
National Policy 29 *Mutual Funds Investing in Mortgages*	**Fund Companies Code, Principle 4 (Conflicts of interest), Principle 7 (Liquidity and risk management) and Principle 8 (Valuation)**
CSA Notice 92/1 *Soft Dollar Transactions*	**Fund Companies Code, Principle 4 (Conflicts of interest)**

What the Proposals Do Not Replace

The Proposals do not replace the following provisions of the Act, Rules and certain national and local instruments, but we would simplify and streamline them where appropriate:

Act

- s. 34 *Persons who must be registered*
- s. 35 *Granting registration*
- s. 36 *Conditions imposed on registration and registrants*
- s. 37 *Subsequent application*
- s. 38 *Further information may be required from applicant*
- s. 39 *Compliance review of registrant*
- s. 40 *Termination or suspension of employment*
- s. 41 *Surrender of registration*
- s. 136(4) *Reimbursement for front running*
- s. 139 *Rescission of purchase of mutual fund security*
- s. 140 *Limitation period*

Rules

Part 5 Registration

- *Division 2 Categories of Dealers and Advisers and Related Provisions*
  - s. 13 *Refusal to register or to renew registration*
- *Division 3 Registration – General*
  - s. 15 *Jurisdiction of organization or incorporation of registrants*
  - s. 17 *Executive director's conditions of registration*
  - s. 18 *Summons for examination under oath*
- *Division 4 Capital and Bonding*
  - s. 19 *Dealer's and underwriter's risk adjusted capital and working capital*
  - s. 20 *Adviser's minimum working capital*
  - s. 21 *Bonding requirement*
  - s. 22 *Notice of change in or claim under bond*
  - s. 23 *Compensation or contingency trust fund*
  - s. 24 *Requirements for not holding funds or securities*
  - s. 25 *Subordination agreement*
- *Division 5 Record Keeping and Reporting*
  - s. 26 *Interpretation*
  - s. 27 *Record keeping by registrant*
  - s. 28 *Adequate precautions and access*
  - s. 29 *Blotters*
  - s. 30 *Registrant's ledgers*
  - s. 31 *Client's ledger accounts*
  - s. 32 *Securities and exchange contracts position report*
  - s. 33 *Orders and instructions*
  - s. 34 *Confirmations and statements*
  - s. 39 *Record of account*
  - s. 40 *Records of options granted or guaranteed by a registrant*
  - s. 41 *Monthly capital record*
  - s. 42 *Time for keeping records*
- *Division 6 Client Accounts and Statements of Account and Portfolio*
  - s. 43 *Interpretation*
  - s. 45 *Underwriter's due diligence procedures*
  - s. 49 *Explanation of relevant terms and conditions*
  - s. 51 *Separate supervision of accounts and pooling*
  - s. 52 *Change in ownership or sale of account*
  - s. 55 *Unencumbered securities held under safekeeping agreement*
  - s. 56 *Unencumbered securities held in segregation*
  - s. 57 *Clients' fee credit balances*
  - s. 58 *Clients' subscriptions or prepayments*
  - s. 58.1 *Membership in self-regulatory organization and handling of clients' money*
  - s. 58.2 *Mutual fund money*
  - s. 59 *Purchase or sale of exchange contract on margin*
- *Division 8 Registration and Amendments to Registration*
  - s. 64 *Application for registration*
  - s. 67 *Duration of registration*
- *Division 9 Financial Statements and Financial Reports*

  - s. 69 *Annual financial statements*
  - s. 70 *Other financial reports*
  - s. 71 *Audits*
  - s. 72 *Registrant's direction to auditor*

Part 12 Continuous Disclosure
- *Division 2 Filing*
  - s. 153 *Filing of material sent to security holders or filed in other jurisdictions*
  - s. 154 *Filing of records filed in another jurisdiction*

National Instrument 81-102 *Mutual Funds*
- Part 5 *Fundamental changes*
- Part 6 *Custodian of portfolio assets*
- Part 10 *Redemption of securities of a mutual fund*
- Part 11 *Commingling of cash*
- Part 14 *Record date*
- Part 15 *Sales communications and prohibited representations*
- Part 16 C*alculation of management expense ratio*

National Instrument 81-104 *Commodity Pools*
- Part 6 *Redemption of securities of a commodity pool*

Proposed National Instrument 81-106 *Investment Fund Continuous Disclosure* (with some exceptions as discussed above)

BC Instrument 81-501 *Mutual Funds Management Expense Ratio Calculation Transitional Relief*

APPENDIX A

The Australian Approach

A principles-based approach to mutual funds is a concept that is in use in other parts of the world. To provide some context for our Proposals in the Fund Company Code (see Chapter 2) to replace Parts 2 and 3 of National Instrument 81-102 *Mutual Funds* with just two Principles, we have summarized the Australian approach to the regulation of managed investment schemes.

In Australia, the Australian Securities and Investment Commission (ASIC) regulates mutual funds as “managed investment schemes” under its *Corporations Act 2001* and the *Financial Services Reform Act 2001*. That legislation does not prescribe how a managed investment scheme must invest its money. Rather, the system requires the scheme itself to be registered, the person who runs the scheme to be a public limited liability company licensed as a responsible entity for the scheme and requires independence either at the board level of the responsible entity or through an independent compliance committee.

To quote Alan Cameron, Chairman of ASIC, speaking in March 1998 to the Parliamentary Joint Committee on Corporations and Securities relating to the Managed Investments Bill 1997:

> This Bill takes an outcomes based approach to all of these requirements. It does not specify how you achieve things; it specifies what the result is to be.

1. Scope of the regime

The regime applies to any managed investment scheme. The definition of managed investment scheme includes many of the concepts from the North American courts’ interpretation of investment contract. It includes a scheme where people contribute money to acquire interests in the scheme, the contributions are to be pooled or used in a common enterprise and the members do not have day-to-day control over the operation of the scheme. There is then a long list of exclusions, including exclusions for companies, certain partnerships, various pension and insurance products and co-operatives.

Managed investment schemes cover a wide variety of investments. In addition to covering conventional mutual funds, the regime also would cover closed end funds, project financing, film and agricultural schemes, mortgage schemes and other collective investment schemes.

As a result of the broad range of investment schemes covered by the regime, there is no obligation for the investors’ funds to be redeemable on demand or for any diversification of assets.

2. Registration of the scheme

A scheme must be registered if it is offering to retail clients. To register, the responsible entity files the scheme's constitution and the scheme's compliance plan. A scheme must also deliver a product disclosure statement to retail investors.

The scheme's constitution is the trust deed of the scheme. The constitution sets out:

- How much it costs to buy interests in the scheme.
- Any withdrawal rights, including procedures for dealing with withdrawal requests.
- The investment powers of the responsible entity.
- Any powers of the responsible entity to borrow or raise money for the scheme.
- Any fees or indemnification payable to the responsible entity out of scheme property.
- The methods for dealing with members' complaints.
- Adequate provision for the winding up of the scheme.

The compliance plan sets out how the responsible entity would run the scheme. The compliance plan is discussed in more detail below.

3. Licensing of the responsible entity

To be licensed, a responsible entity must satisfy the ASIC that it has the competency, skills and resources to manage the scheme.

The competency must relate to the assets of the scheme. For example, if the scheme planned to invest in equities, then the responsible entity must have competency in equities. If the scheme planned to invest in derivatives, it must have competency in derivatives.

The responsible entity must have a specified level of net tangible assets either directly or indirectly. If the responsible entity doesn't have the required level of net tangible assets, it must hire a custodian who does. An outside custodian must have $5 million in assets in virtually all circumstances. A responsible entity must carry professional indemnity and fidelity/fraud insurance of at least $5 million.

The responsible entity must also have a compliance plan that deals with risks to the scheme (see below). The responsible entity must also have internal complaints procedure and must participate in an ASIC approved external complaints system.

4. Compliance plan

The compliance plan must set out measures the responsible entity will apply in operating the scheme to ensure compliance with the legislation and the scheme's constitution.

Compliance plans vary widely depending on the type of scheme.

The Act requires the compliance plan to include arrangements for:

- Separating scheme property from other property of the responsible entity or any other scheme.

- Valuing scheme property regularly at appropriate intervals based on the nature of the property.
- Ensuring that compliance with the plan is audited.
- Ensuring that adequate records of the scheme's operations are kept.

To prepare a compliance plan, a responsible entity reviews responsibilities under the Act and the scheme's constitution, identifies the risks of non-compliance and establishes measures to meet those risks. For schemes equivalent to public mutual funds in Canada, the compliance plan establishes processes, systems and structures relating to:

- Safekeeping and segregating scheme property
- Auditing
- Valuation issues
- Accounts and record keeping
- Applications, redemptions and distributions
- Conduct of business issues (including for example best execution, fair allocation, investment objectives, liquidity and other investment risks)
- Disclosure and reporting
- Related party issues
- Fees and expenses
- Use of external service providers
- Complaints handling
- Compliance
- Indentifying, rectifying and reporting breaches
- Training, recruitment and experience
- Distribution channels

In most cases, the plan sets out processes to address risks. For example, in looking at calculation of unit price, the compliance plan sets out the process for pricing, whether someone reviews the work of the person calculating the price, any reporting requirements if there are unusual price movements, and how errors are corrected. The ASIC's policy statement on compliance plans sets out a series of questions to be answered in each of the areas noted above.

5. Compliance monitoring

The responsible entity must report compliance to its board of directors if it has enough independent members or to the compliance committee. If at least half of the members of the board of directors are not independent, the responsible entity must establish a compliance committee with a majority of independent members. If there is a compliance committee, it would:

- Monitor the responsible entity's compliance with the compliance plan and applicable law and report its findings to the responsible entity;
- Report to the ASIC if the committee believed the responsible entity had not taken appropriate actions to deal with breaches reported to it; and
- Assess the adequacy of the compliance plan and recommend changes.

Each year the compliance plan is audited. In addition to the audit of the compliance plan, there are separate audits of the financial affairs of the responsible entity and of the financial affairs of the scheme. The three audit reports are filed with ASIC. The auditor of the responsible entity and the auditor of the compliance plan must be different individuals, although three different individuals usually perform these audits. The people performing the three audits can, however, be from the same firm.

ASIC also monitors compliance by doing compliance reviews. It tends to focus its reviews on where it perceives investors are most at risk. In doing its reviews, ASIC focuses on important risk areas for particular entities. This may relate to compliance with financial licensing requirements, quality of operations, the process of appointing and monitoring agents and the activities of compliance committees. The focus of reviews differs between different entities. However, often ASIC will have a particular theme and concentrate on the same compliance risk at a number of entities. ASIC releases reports summarizing its surveillance findings.

6. Investor Remedies

The responsible entity has a number of duties, many of which are similar to Principles in the Fund Company Code described in Chapter 2. These include duties to:

- Act honestly
- Exercise care and diligence
- Not make improper use of information
- Treat members equally and fairly
- Value scheme property appropriately
- Segregate scheme property
- Act in the best interests of members and avoid conflicts
- Ensure the scheme's constitution and compliance plan meet the requirements of the Act
- Comply with the scheme's constitution and compliance plan

In addition, as the responsible entity holds scheme property in trust for members, the responsible entity has other duties imposed on trustees generally.

The responsible entity may be sued by a a member of the scheme who suffers loss or damage because of conduct that contravenes the Act, including the provisions relating to the scheme's constitution or compliance plan. The responsible entity can only be indemnified from the assets of the fund if it has properly performed its duties.

Directors and officers also have duties, as do members of compliance committees. These include duties to:

- Act honestly
- Exercise care and diligence
- Not make improper use of information or position
- Take all reasonable steps to ensure the responsible entity complies with the law, any licence conditions, the scheme's constitution and the scheme's compliance plan
- Cooperate with the compliance committee and compliance plan auditor
- Report to the ASIC breaches that materially adversely affect members' interests

Members do not have a direct right of action for breach of duty against officers or directors of the responsible entity or against members of the compliance committee. Instead the responsible entity may bring an action against a director who acted in breach of the director's duties and ASIC can bring a civil proceeding against the officer or director (see below).

Members do have a right of action for misrepresentations in a disclosure document as well as general rights of action against directors of a company (e.g. for incurring debts when the company is insolvent) or against directors of a corporate trustee (e.g. if the corporate trustee cannot discharge its liability, the directors of the corporate trustee may have to do so personally).

7. Enforcement

ASIC has a number of powers to enforce compliance with its regime.

First, ASIC can bring civil penalty proceedings against a responsible entity or its directors, officers or employees. Under these proceedings, the court can order a range of civil penalties including penalty orders (up to $200,000), compensation orders (to compensate for damages or repay profits made) or disqualification orders (to disqualify a person from management of a corporation). ASIC can also seek an injunction to prevent a breach.

Second, ASIC can conduct a targeted surveillance review where there are particular concerns about an entity as a result of complaints, intelligence received or notification from the entity of a breach.

Third, ASIC can accept enforceable undertakings from responsible entities. This enables structured settlements with provisions for investor dispute resolution, compensation schemes and upgrading of compliance systems. These are enforceable at law and breach could lead to revocation, suspension or a civil penalty proceeding.

Fourth, ASIC has broad powers to suspend or revoke a licence of a responsible entity for breach of licence conditions. Where members have suffered or may suffer loss, the suspension or revocation can be made without a hearing. Otherwise, a hearing must first be held.

Fifth, ASIC can deregister a scheme if the scheme's responsible entity no longer satisfies the requirements, if the scheme's property is not being kept separate or if the scheme is wound up. Either a member or ASIC can apply to court for a winding up.