# TOWARDS IMPROVED FUND GOVERNANCE:

## THE WAY FORWARD

**David A. Brown**
**Chair**
**Ontario Securities Commission**

**July 27, 2000**

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Over the last decade the Commission has responded to the explosive growth in the investment fund industry with a number of significant initiatives designed to ensure that regulation kept pace with the unprecedented changes in the marketplace. Drawing from recommendations outlined in former Commissioner Glorianne Stromberg's seminal report[1], the Commission and the other Canadian Securities Administrators have invoked their rule-making power to regulate mutual funds' sales practices, to update the regulation of mutual funds' structure and management, and to revamp the simplified prospectus disclosure regime. The Commission and its CSA colleagues have also fostered the creation of the Mutual Fund Dealers Association and have recently published for comment recognition criteria and a draft rule which will require all mutual fund dealers to become members of this important new SRO.

Now as we move into the new millennium, we are setting our sights on a more ambitious project; one that represents both a shift and a leap forward in our thinking about the regulatory framework for mutual funds and other investment funds: this project is the design and implementation of a mutual fund governance regime across Canada.

In early 1999, I asked Stephen Erlichman to provide the Commission and the CSA with his thoughts on how we could move to improve fund governance. Mr. Erlichman's recommendations have been provided in the form of his report entitled "*Making it Mutual: Aligning the Interests of Investors and Managers - Recommendations for a Mutual Fund Governance Regime for Canada*". We are confident that the Erlichman report will serve us well as we move forward into this exciting area. Mr. Erlichman's recommendations reflect his understanding of the Canadian mutual fund industry and are well tailored to the unique features of that industry. The report contains a comprehensive description and analysis of the history of the fund governance debate in Canada and abroad and Mr. Erlichman has ably furthered that debate. We are confident that his report will move us closer to reaching a consensus on its outcome.

We share Mr. Erlichman's position that improvements in fund governance and the management of

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1 *Regulatory Strategies for the Mid-90s - Recommendations for Regulating Investment Funds in Canada.* Prepared for the Canadian Securities Administrators by Glorianne Stromberg, January 1995.

mutual funds are desirable, not so much because there may be problems in the fund industry, but, rather, so that investors' expectations of high standards of conduct from the stewards of their money is not misplaced. However, we also recognize that reforms of our existing rules, which are based on disclosure, fiduciary principles, and restrictions on transactions giving rise to conflicts of interest, are not enough, given the dramatic changes that have occurred in the industry and the marketplace as a whole. We live in a climate of increasing competition and when this is coupled with the unique structure of mutual funds, mutual fund organizations, and the inherently passive nature of the Canadian public's investment in mutual funds it becomes more and more obvious that there is a need for something more.

Mr. Erlichman reminds us that mutual fund governance is not a new concept in Canada. In fact, a report published by the Canadian Committee on Mutual Funds and Investment Contracts pointed out as early as 1969 that securityholders in a mutual fund have little or no effective voice in the affairs of the company managing that fund and their money. It went on to conclude that:

> "The best protection ... would be an arrangement whereby the management company and the distribution company were subjected to continuing independent scrutiny over their operations. Such a scrutiny might be provided by the mutual fund investors, or by a surrogate acting on their behalf."[2]

While we agree with earlier commentators that a well-defined fund governance regime--based on the increased scrutiny of fund managers by independent groups who have responsibility to look after the investors' best interests--is a desirable thing, we still need to grapple with the form that such a regime should take in this country. We must carefully consider the issues and the alternatives as we embark on this long-anticipated path.

We are releasing the Erlichman report at this time to ensure that the mutual fund industry and the Canadian public also have ample opportunity to consider the issues surrounding mutual fund governance well in advance of any proposal by the Canadian Securities Administrators to enter into this new area of mutual fund regulation. We hope that our early release of the recommendations made by Mr. Erlichman will result in a more informed dialogue. Exploring the full range of perspectives and canvassing options for improving fund governance and the management of mutual funds is a Commission priority for the upcoming year. We not only intend to dialogue with international securities regulators and scholars, but we will also engage industry participants and investors as we seek to fashion a thoughtfully crafted regime. You can expect to hear from us as we move forward.

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2 *Report of the Canadian Committee on Mutual Funds and Investment Contracts - Provincial and Federal Study, 1969*, Queen's Printer, 1969 at p. 151, 152.

# *MAKING IT MUTUAL: ALIGNING THE INTERESTS OF INVESTORS AND MANAGERS*

## RECOMMENDATIONS FOR A MUTUAL FUND GOVERNANCE REGIME FOR CANADA

Prepared for the Canadian Securities Administrators
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*MAKING IT MUTUAL: ALIGNING THE INTERESTS OF INVESTORS AND MANAGERS*

**RECOMMENDATIONS FOR A MUTUAL FUND GOVERNANCE REGIME FOR CANADA**

**C O N T E N T S**

## I. EXECUTIVE SUMMARY

This report was undertaken for the Canadian Securities Administrators ("CSA") at the request of the Chair of the Ontario Securities Commission ("OSC"). My mandate, in general terms, was to provide recommendations to the CSA on establishing a governance regime for publicly-offered mutual funds in Canada. This report describes the history of the mutual fund governance debate in Canada, publicly reported issues on the manager side of the mutual fund industry, potential positive benefits should a governance regime be implemented, types of mutual fund governance structures in existence elsewhere in the world, mutual fund governance reforms in other jurisdictions and my recommendations with respect to establishing a governance regime for mutual funds in Canada.

What do we mean when we speak of mutual fund governance? At its most basic level, I suggest that it refers to having a system in place whereby decisions in a mutual fund complex are made in the best interests of the securityholders of the mutual funds rather than in the best interests of any other party.

Since the commencement of this project, I have been asked on many occasions why it is either desirable or necessary to have a mutual fund governance regime in Canada, especially if mandating a governance regime results in increased costs in a mutual fund complex that in some manner will be passed on to investors. I first contemplated this question in 1993 when I started my research for a short paper relating to managing conflicts of interest in the mutual fund industry.[1] At that time, I recognized that Canada already had: a structure which creates a statutory standard of care and duty of loyalty, as well as common law fiduciary duties, for various parties involved in a mutual fund complex; a set of conflicts rules relating to mutual funds; and required disclosure in a mutual fund's prospectus and annual information form of all material facts relating to the mutual fund securities offered under the prospectus. Inasmuch as the CSA of their own accord decided to re-examine mutual fund governance in Canada at this time, I am sure that the CSA will have their own answers to the query that was posed to me, but my response is as follows.

First, the mutual fund structure in Canada, by its very nature, is rife with actual and potential conflicts. For example, mutual funds are organized and operated by persons who are employed by entities other than the mutual fund itself. Accordingly, these people have pecuniary interests in the manager or other entities apart from the mutual fund. As a result, there are inherent potential conflicts of interest in the mutual fund structure between the interests of the securityholders of the mutual fund, on the one hand, and the interests of the manager of the mutual fund and other persons rendering services to the mutual fund, on the other hand. In addition, in a typical Canadian mutual fund structure the trustee, manager and investment adviser and, in some cases, the registrar and transfer agent may be the same entities or may be entities within the same corporate group, thereby also raising potential conflicts. Some conflicts are addressed by existing conflicts rules while others are not. The fact that conflicts are inherent in the mutual fund structure, however, may create a public perception that the conflicts lead to abuses. In an industry where having the trust and confidence of the public is essential, I suggest that it is critical to reduce to a minimum level any adverse public perception.

Second, there are a few publicly reported decisions in Canada that show problems can exist on the manager side of the Canadian mutual fund industry. Perhaps the most notable of these is the recent decision by the OSC with respect to Infinity Investment Counsel Ltd. and Fortune Financial Corporation.[2] Some of these problems exist because mutual fund complexes are not cognizant of their fiduciary duties. With the Canadian mutual fund industry reported to have more assets under administration than savings deposits in the Canadian banking system,[3] abuses could place investors' savings at risk. Accordingly, I suggest that we must try to reduce the potential for such abuses arising.

Third, although Canadians are not as litigious as our neighbour to the south, I suggest that trying to prevent problems ahead of time through a governance regime is a more efficient way to handle issues rather than resorting to litigation to resolve problems that might not have arisen or might have been alleviated had an effective governance regime been in existence in the first place.

Fourth, depending upon the type of governance regime that is established, the existence of a governance regime might lead to the loosening of the conflicts rules relating to mutual funds, with the securities regulatory authorities relying on the governance mechanism to monitor transactions that otherwise would be prohibited or would require exemptions from existing securities laws. If this result occurs, then in effect there will be a transfer of some regulatory oversight from the CSA to the governance mechanism.

Fifth, there are certain realities of the Canadian mutual fund marketplace that suggest it would be unfair to investors to force them to rely on the market mechanism of "voting with one's feet" in lieu of an effective governance regime. In Canada the majority of mutual fund securities are sold on a back-end load basis. In addition, mutual fund investors, more than investors in individual public corporations, are passive investors who are told by the fund industry to take a long term perspective on their mutual fund investments. Accordingly, I suggest that an investor should not be forced to exit because the cost of "voting with one's feet" is contrary to the emphasis that the mutual fund industry places on investing for the long term and also because a forced exit may have associated costs, such as payment of redemption fees or, in the case of mutual fund securities held outside of registered plans, realization of a capital gain or loss which may be undesirable.

Sixth, but certainly not least important, there is some empirical evidence in the corporate area, and to a lesser extent in the pension fund and mutual fund areas, which suggests that better governance leads to better performance for investors. In the corporate context the Dey Report[4] stated that "[w]e believe that effective corporate governance will, in the long term, improve corporate performance and benefit shareholders".[5] Much work still has to be done in this area to develop more empirical evidence, but I suggest that in the absence of such evidence we should rely on common sense and make "empirical assumptions" with respect to the relationship between fund governance and fund performance. In this regard, let me quote Ira M. Millstein, a well-known commentator on and participant in corporate governance issues in the U.S.:

> "Good corporate governance is based on the seemingly noncontroversial premise that an independent attentive board, structured to monitor management's performance, is more likely to detect and address problems and provide real accountability to shareholders. …
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> …In 'The Origin of the Species,' Darwin noted, 'A grain in the balance will determine which individual shall live and which shall die.'
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> I suggest that an independent, attentive board is the grain in the balance that leads to a corporate advantage. …
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> …Shareholders rely on professional managers to carry on the business, and this distinct specialization of investment and management has proved uniquely successful. Nonetheless, human nature being what it is, the shareholders' agents, the managers, may tend to forward their own interests, with the danger that they will make decisions, or become entrenched or enrich themselves, at the expense of the shareholders. An independent attentive board serves as a monitor to the shareholders to lessen the impact of this agency problem.
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> I don't think we really need to try to prove mathematically that such a board is needed. In a recent article, Mr. Solow [a Nobel laureate in economics] aptly identifies the problem in the search for econometric 'proof' of which I complain. 'In economics, model builders' busywork is to refine their ideas to ask questions to which the available data cannot give the answers,' he wrote, likening this to having 'the overeducated in pursuit of the unknowable.' 'There is a tendency to undervalue keen observation and shrewd generalization,' he added, noting that 'there is a lot to be said in favor of staring at the piece of reality you are studying and asking, just what is going on here?'
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> …[W]hy not bow to Darwin's logic and accept the grain that may well tip the balance in favor of survival: the board that is performing well? I see no need to await definitive proof. It probably will never come, and it isn't necessary."[6]

One should understand that designing a governance regime is not a science but rather is an art. As Martin Lipton, a well-known U.S. lawyer, has stated in the corporate governance context:

> "There are some people who know what an ideal corporate governance world is. I don't."[7]

I do not believe that there is only one correct answer to the question of what mutual fund governance regime should be established in Canada. If there was but a single right answer, then one would think that the debate on mutual fund governance which began in Canada in 1969 with the publication of the seminal "Report of the Canadian Committee on Mutual Funds and Investment Contracts"[8] should have resulted in a definitive conclusion sometime during the last thirty years. In fact, there are various mutual fund governance regimes in existence today around the world.[9] I also understand that contemporaneously with the preparation of this report, the International Organization of Securities Commissions is reviewing mutual fund governance in many countries. Coincidentally, some systems are in the process of being reformed even as such review is being undertaken. There is no current worldwide consensus – nor is there even any consensus in Canada – that any one system of mutual fund governance is the best in comparison to others.

During my discussions in preparing this report, one person jokingly called me the "Moses" who had been retained by the CSA to guide us to the promised land. The concern was voiced that the CSA do not understand that we are in the promised land now and whatever recommendations I make may lead us in the wrong direction. I am not Moses nor for that matter am I an economist or a private investigator. The CSA and the mutual fund industry can decide for themselves what direction they believe the recommendations in this report will take us.

Some of my recommendations will require the enactment of new laws. Others, however, can be adopted voluntarily by the mutual fund industry or, if not adopted voluntarily, might in effect be forced upon members of the fund industry by the CSA denying exemptive relief unless the recommendations are adopted. The basis for the denial of the exemptive relief by the CSA would be that it is not in the public interest for the exemptive relief to be granted unless the fund organization has adopted those recommendations set out in this report which are accepted by the CSA.

With the foregoing in mind, let me summarize my key recommendations, which I explain and elaborate upon later in this report:

1. Each mutual fund complex should be required to establish a governance regime that has a governing body independent from the manager of the mutual funds.

   In an ideal world, a mutual fund complex would have flexibility in determining the type of governance regime it wishes to adopt. The CSA could then monitor Canadian mutual fund complexes which have adopted different governance regimes and also monitor the mutual fund governance regimes that are recommended and implemented elsewhere in the world and, based upon the evidence garnered from such monitoring, decide at some future date to mandate a specific governance regime. In this flexible model, the types of regimes that in theory could be established by a mutual fund complex include:

   (a) a corporate trustee independent of the manager;

(b) a corporate trustee which is not independent of the manager but which has a governance committee of its board comprised of at least a majority of individuals who are independent of the manager;

(c) a governance committee of the board of directors of the manager, comprised of at least a majority of individuals who are independent directors;

(d) an advisory board (of directors, governors or trustees, as the case may be) of each mutual fund or of a group of mutual funds comprised of at least a majority of individuals who are independent; or

(e) a "corporate style" board (of directors, governors or trustees, as the case may be) of each mutual fund or of a group of mutual funds comprised of at least a majority of individuals who are independent.

Again, in an ideal world, the recommendations in subsections 2(a) to (m) relating to a corporate style board could be used as guidelines and applied, to the extent applicable and with appropriate changes, to the type of governance regime established by the mutual fund complex.

In this theoretical model where the CSA do not mandate a specific governance regime at this time but rather permit each mutual fund complex to choose the type of regime it wishes to follow for the time being, the CSA could consider whether to create incentives for mutual fund complexes to adopt a specific form of governance regime by preconditioning certain exemptive relief (from some of the existing mutual fund conflicts rules or from some requirements of National Instrument 81-102, for example) on the mutual fund complex having adopted the particular form of fund governance regime.

The theoretical model which provides flexibility to mutual fund organizations to choose one of several types of independent governance regimes is, however, a model that I believe would cause difficulties in practice, for reasons set out in this report.

2. If the CSA decide to mandate one specific form of fund governance regime at this time, then I recommend that each mutual fund should have a "corporate style" board (of directors, governors or trustees, as the case may be). Mutual fund corporations already have boards of directors and some mutual fund trusts have individual trustees who collectively constitute a board of trustees. In the case of mutual fund trusts that have a corporate trustee, the corporate trustee should be replaced by a board of individual trustees. If the CSA mandate such a board structure, I believe that there should be some flexibility built into the system and it should not blindly mirror the U.S. mutual fund governance regime. I recommend that the board of a Canadian mutual fund should be constituted and should operate as follows:

(a) The board should consist of at least three individuals of whom at least a majority and preferably at least two-thirds are independent of the manager. The definition of what constitutes an "independent" member should be modeled on the Dey Report's definition of "unrelated" director[10] rather than on the complex and detailed rules used in the U.S. *Investment Company Act of 1940*.[11]

(b) There should be no restriction on the same individuals being on the boards of more than one or all of the mutual funds in a fund complex.

(c) The independent members of the board initially would be selected and appointed by the manager. Thereafter the independent members would be appointed by the full board (and not by the manager nor by the independent members alone) or in the case of a corporate mutual fund they would be elected by the fund's shareholders as required by the fund's governing corporate statute, in either case based upon the recommendations of a nominating committee composed of at least a majority of directors who are independent of the manager.

(d) The salaries of the independent members should be determined by the board, but in the first instance they could be established by the manager and the board jointly.

(e) The salaries of the independent members, as well as any additional expenses of having a board, could be paid either by the mutual fund or by the manager.

(f) The board, as well as the independent members as a separate group, should have the power to seek whatever professional advice and incur whatever expenses they reasonably require to carry out their duties, with the cost of such advice being borne either by the mutual fund or by the manager. These expenses would be paid by the mutual fund if the manager does not agree to pay them.

(g) The board should have the general responsibility to supervise the management of the business and affairs of the mutual fund in order that decisions affecting the mutual fund are made in the best interests of the securityholders of the mutual fund. The board need not have a detailed list of specific duties, but certain minimum responsibilities should be established. The minimum duties could include: (i) evaluating the performance of the manager in various categories (including in providing an adequate level of service to securityholders and in producing acceptable investment returns for the mutual fund, before and after expenses, in comparison to appropriate benchmarks that take into account the mutual fund's risk profile); (ii) reviewing the financial statements of the mutual fund; (iii) checking that the mutual fund is following its investment objectives; (iv) monitoring the manager's compliance with the mutual fund's compliance plan; and (v) making decisions on behalf of a mutual fund whenever conflict of interest issues arise between the mutual fund and any other party. In addition to the specified minimum duties, the board should have the flexibility to determine what else it should do to fulfill its broader general mandate. The board should not have the right to terminate the manager. The board should be given sufficient power to carry out its responsibilities.

(h) Board members should have a standard of care similar to that of directors of a business corporation.

(i) Each board should have a lead member, who will be one of the independent members. The lead member should be responsible for managing the processes of the board. The lead member should monitor the mutual fund on a regular basis and should be the key person who interacts with the fund manager on issues relating to the mutual fund.

(j) Each board member should be entitled to be indemnified from the assets of the mutual fund (and, if these are not sufficient, from the assets of the manager) for liabilities incurred while carrying out his or her duties, provided the board member has not fallen below the board's standard of care.

(k) The board should be authorized to purchase appropriate liability insurance for the benefit of its members at the expense of the mutual fund, but such insurance should not cover any liability resulting from not satisfying the board's standard of care.

(l) If the board and the manager cannot agree on any issues, the board or the manager should report such matters to the CSA or to the securityholders of the mutual fund or, in appropriate circumstances, call a meeting of mutual fund securityholders to vote on the issues. To whom the report is made and whether a securityholder meeting will be called will be a decision of the board or the manager, as the case may be, based upon the nature of the matter in dispute. The CSA, however, should not be required to function as a mediator.

(m) The manager, directly or through a trade organization, should provide sufficient education programs to new board members and to all board members on an ongoing basis. Board members also should have the right to supplement these education programs by attending outside seminars at the expense of the manager or, if the manager is unwilling to pay the costs, at the expense of the mutual fund.

3. Each mutual fund manager should be required to be registered with the CSA. Conditions of registration should include minimum proficiency requirements, minimum capital requirements, minimum insurance requirements, the establishment of an audit committee and implementation of various internal controls as well as controls to monitor external service providers.

4. Each mutual fund should have a compliance plan which is filed with the CSA. The compliance plan, as well as the manager's compliance with the plan, should

be reviewed periodically, at least by the governance body and, if the governance body or the CSA wish, by an external auditor. An annual review of the compliance plan and the manager's compliance with the plan should be filed with the CSA as part of the annual mutual fund prospectus renewal process and should be made available for public inspection. The compliance plan, if properly reviewed and monitored by the mutual fund's governance body, should create a due diligence defence for the governance body and for the manager of the mutual fund against claims alleging breaches of matters covered by the plan.

5. In any jurisdiction where such duty is not already clearly legislated, laws should be enacted to create a statutory fiduciary duty of the governance body and of the manager similar to section 116 of the *Securities Act* (Ontario) in favour of the securityholders of the mutual fund. Laws also should be enacted to specify that in the event there is a conflict between the duty of the governance body, the manager or individual directors or officers to the mutual fund securityholders and any duties to other parties, the duty to the mutual fund securityholders would take precedence. The governance body also should be given the benefit of a legislated "business judgment rule".

6. Laws should be enacted to ensure that securityholders of all mutual funds have uniformity in treatment on certain issues, including with respect to the percentage of securityholders required to call meetings of securityholders, quorum requirements for securityholder meetings and the percentage of votes required to take action at securityholder meetings. Securityholders of all mutual funds should

have certain specific powers, including, if the governance body is a corporate style board, the power to call meetings of securityholders in order to remove and replace members of the board.

7. The CSA should encourage the development of a mutual fund investor compensation plan to protect securityholders against any losses that could result from the insolvency or fraud of a mutual fund manager. In addition, laws should be enacted to ensure that unitholders of mutual fund trusts have limited liability, similar to shareholders of mutual fund corporations.

8. The CSA should have sufficient powers to inspect and discipline all actors in the mutual fund complex, including the mutual fund, its manager and, if applicable, its trustee. If current powers in any jurisdiction are not sufficient, laws should be enacted to provide such powers to the CSA. The CSA should effect inspections on a regular basis and publicly report the results of problems encountered.

9. Each mutual fund complex should be required to disclose:

   (a) the mutual fund complex's approach to fund governance, including: (i) the basis upon which the mutual fund organization has concluded that the independent governance body is independent; and (ii) a description of each mutual fund's compliance plan. The CSA should consider whether governance disclosure should be moved from the annual information form to the simplified prospectus or made available to investors on some other basis, such as on the fund complex's internet website; and

   (b) in the simplified prospectus, the guidelines that the manager or the portfolio adviser follows in determining whether and how to vote portfolio securities at shareholders' meetings of companies held in the portfolios of the mutual funds. The CSA should consider whether such disclosure also should be made in some other manner, such as on the fund complex's internet website.

10. Best practice guidelines relating to Canadian mutual fund governance should be developed from time to time by the CSA in conjunction with the mutual fund industry.

I also recommend that a consultative process should be undertaken with the mutual fund industry to review and consider these recommendations before they are adopted. In addition, because better governance is not an end in and of itself but rather is a means to an end, these recommendations and whatever governance regime is implemented as a result of these recommendations should be re-evaluated in light of any future empirical evidence that is developed as to whether problems exist in the Canadian mutual fund industry, whether better fund governance leads to better fund performance and whether the governance regime is responsive to the other matters raised at the beginning of this Executive Summary. The purpose of the re-evaluation would be to determine whether any of these recommendations or the adopted governance regime should be altered in light of such empirical evidence and thereby establish a more effective and efficient mutual fund governance regime.

I encourage the readers of this Executive Summary to read the remainder of this report for a full description of these recommendations and the reasons for them.

There is no consensus in Canada as to whether a new mutual fund governance regime is necessary or appropriate nor, if Canada is to have a new fund governance regime, what type of regime should be established. Accordingly, the recommendations in this report will not find acceptance in some quarters of the mutual fund industry and perhaps even with some members of the CSA. I hope, however, that the CSA and the mutual fund industry ultimately embrace these recommendations and that fund organizations improve upon and tailor these recommendations to the distinct circumstances of their mutual fund complexes. I know from personal experience that the Canadian mutual fund industry is extremely innovative and I would not be surprised if some fund organizations discover that they can use their models of mutual fund governance to assist them in marketing their sponsored mutual funds.

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[1] S.I. Erlichman, "Managing Potential Conflicts of Interest" in *Mutual Funds: New Products, New Competitors, New Rules* (Toronto: The Canadian Institute, 22 October 1993).

[2] *Singh (Re)* (1999), 22 O.S.C.B. 462.

[3] John A. Geller, Q.C., the Vice-Chair of the Ontario Securities Commission, recently stated that "Canadians now have more money invested in mutual funds than on deposit with banks and trust companies" (See "In the Best Interests of Investors: Strengthening Fund Governance" (Keynote Address to The Canadian Institute's Eighth Annual Mutual Funds Symposium, Toronto: The Canadian Institute, 18 October 1999) which can be found at (1999) 22 O.S.C.B. 6557). The Investment Funds Institute of Canada ("IFIC") reported assets under management by its members of $413.5 billion as at March 31, 2000 and IFIC has advised that, as at that date, almost 100% of mutual fund managers in Canada were members of IFIC (Statistics can be found on the IFIC website at www.ific.ca/eng/frames.asp?I1=statistics). This figure may be compared to savings deposits in the Canadian banking system as at March 31, 2000, which totaled $338.6 billion (Bank of Canada Banking and Financial Statistics).

[4] *Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada: "Where Were the Directors": Guidelines for Improved Corporate Governance in Canada* (December 1994) (Chair: P. Dey, Q.C.) [hereinafter *Dey Report*].

[5] *Ibid.* at 2.

[6] I.M. Millstein, "Red Herring Over Independent Boards" *The New York Times* (6 April 1997) Money & Business 10.

[7] H. Kaback, "Martin Lipton: For the Defense" (Summer 1999) Directors & Boards at [10].

[8] *Report of the Canadian Committee on Mutual Funds and Investment Contracts – Provincial and Federal Study, 1969* (Ottawa: Queen's Printer, 1969).

[9] The description of the "to-ing and fro-ing" behind the implementation of the recent Australian fund governance legislation described in Part VI of this report under the heading "Mutual Fund Governance Reforms in Other Jurisdictions – 1. Australia – History" shows that mutual fund governance can raise legal, political and other policy issues that do not have clearcut answers.

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[10] *Dey Report*, *supra* note 4 at 24.

[11] 54 Stat. 789 (15 U.S.C. 80a-1 et. seq.).

## II. MANDATE AND METHODOLOGY

This report was undertaken for the CSA at the request of the Chair of the OSC in early 1999. The genesis for this project was a meeting of the CSA held in the spring of 1997, at which time the CSA approved the Report of the CSA Investment Funds Implementation Group[1] (the "Implementation Group"). The Implementation Group was organized as a result of the decision of the CSA in late 1996 to constitute a high-level CSA committee to consider if the CSA should tackle implementation of the various recommendations for regulating mutual funds in Canada made in January 1995 by then Commissioner Glorianne Stromberg of the OSC, as commented on in the November 1996 report of the Investment Funds Steering Group to the CSA.[2] The Implementation Group ranked governance of investment funds as a high priority and proposed that the CSA "develop rules to regulate the governance of investment funds"[3] and "commence work on this recommendation in priority to those recommendations that depend upon the independent governance mechanism being resolved".[4] The Implementation Group recommended that designated CSA staff form a group to review this area and recommend appropriate rules, seek outside legal expertise where necessary, and consult with The Investment Funds Institute of Canada ("IFIC") and fund manager representatives.[5]

My mandate, in general terms, was to provide recommendations to the CSA on establishing a governance regime for publicly-offered mutual funds in Canada. In response to this mandate, I decided that this report should:

(i) review the history of the debate surrounding mutual fund governance in Canada;

(ii) describe publicly reported issues on the manager side of the mutual fund business;

(iii) consider potential positive benefits should a mutual fund governance regime be implemented;

(iv) describe how mutual fund governance is dealt with in various jurisdictions outside of Canada;

(v) highlight mutual fund governance reforms being implemented or considered in other jurisdictions; and

(vi) recommend a fund governance regime for publicly-offered mutual funds in Canada.

I also should point out that there are various issues that my mandate does not include, such as:

(i) considering governance structures for any vehicle other than publicly-offered mutual funds (such as pooled funds, segregated funds, hedge funds or wrap programs);

(ii) deciding whether products which compete with publicly-offered mutual funds would have a competitive advantage over mutual funds should a governance regime be implemented for publicly-offered mutual funds only; or

(iii) determining whether any abuses exist today on the management side of Canadian mutual fund organizations which have not been publicly disclosed and which a governance regime would most effectively and efficiently be able to rectify or assist in rectifying.

In approaching this project, it is important to understand that we are not starting with a clean slate in Canada. If one were to design a governance regime for mutual funds *ab initio*, one might create something that is very different from the recommendations in this report. For example, the "*mutual* mutual fund model" adopted by the Vanguard Group in the United States, which I describe in Part V of this report entitled "Survey of Mutual Fund Governance Structures" under the heading "5. An Innovative Model", is perhaps the purest example of a structure which aligns the interests of the mutual fund securityholders with the interests of the mutual fund manager. It would not be viable to require that all mutual fund complexes implement such a model in Canada, however, if one believes in a capitalist system that rewards entrepreneurial efforts. Accordingly, some models may be good in theory yet may not be implementable in practice.

One also should keep in mind that most mutual funds in Canada are trusts, which are creations of common law, while a small percentage of Canadian mutual funds are corporations. Thus, in making my recommendations I had to be cognizant of the principles of the laws of trusts, including fiduciary duties inherent in the common law trust structure, as well as corporate law, and to be comfortable that my recommendations, if accepted, could be implemented in the framework of both mutual fund trusts and mutual fund corporations.

In preparing this report I gathered and read numerous materials and met with many people. To assist me in obtaining the views of the Canadian mutual fund industry with respect to fund governance I also prepared a questionnaire (a form of which is annexed as Schedule A to this chapter) which was sent out to the mutual fund industry. A summary of the responses I received to the questionnaire is annexed as Schedule B to this chapter.

I delivered a draft of this report to the CSA on February 2, 2000. I delivered the final version of this report to the CSA on June 1 after considering comments on the draft, but the background research for this report generally has not been brought forward beyond February 2.

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[1] "Report of the CSA Investment Funds Implementation Group endorsed by the Canadian Securities Administrators" (1997) 20 OSCB 2512 [hereinafter *Implementation Group Report*].

[2] Investment Funds Steering Group, *The Stromberg Report: An Industry Perspective*, Prepared for the Canadian Securities Administrators (Toronto: Queen's Printer, November 1996).

[3] *Implementation Group Report*, *supra* note 1 at 2515.

[4] *Ibid*.

[5] *Ibid*.

# SCHEDULE A

## QUESTIONNAIRE

Name of Organization: ___________________________________________________

1. (a) Does your organization have any mechanism in place (for example, a board of directors or advisory board for your mutual funds, or independent directors of the manager of your mutual funds) that has been established to deal with mutual fund governance issues?

   (b) If your answer to question 1(a) is yes:
   (i) Please describe the mechanism and its mandate.

   (ii) Has the mechanism been effective in fulfilling its mandate? Please explain.

   (iii) Are there specific problems that this mechanism either (A) has discovered and resolved, or (B) has resolved even though discovered by others in the organization? Please explain.

   (c) If your answer to question 1(a) is no:
   (i) Have you considered adopting such a mechanism?

   (ii) Why have you not adopted such a mechanism?

2. Are there problems or issues in the Canadian mutual fund industry that you believe a mutual fund governance mechanism could solve or alleviate? If yes, please explain.

3. Do you believe that a governance mechanism is necessary or is appropriate in the Canadian mutual fund industry? Please explain.

4. Would your answer to question 3 change if one consequence of adopting a governance mechanism was that the existing conflicts regime for mutual funds in Canada was simplified?

5. If a governance regime is implemented in the Canadian mutual fund industry, do you have any thoughts on the type of regime that should be adopted? For example, should each mutual fund or each mutual fund family have a board of directors (of which a portion must consist of independent directors) or an advisory board, or should the manager of the mutual fund be required to have independent directors with a mandate to look out for the best interests of the unitholders of the mutual funds (rather than the shareholders of the manager)?

6. If a governance mechanism is implemented in the Canadian mutual fund industry, who should pay for the costs of the mechanism? Should the expenses be the responsibility of the mutual funds themselves (thereby passing the costs on to the unitholders) or of the manager?

7. (a) Should mutual funds, their managers or their advisors be legally required to adopt and enforce codes of ethics designed to try to prevent activities that are unlawful or not in the best interests of the unitholders of the mutual funds?

   (b) If your answer to question 7(a) is yes, who should monitor and enforce such codes?

8. Should the company that manages a mutual fund be required to be registered with a securities commission even if the management company is not registered as an advisor or dealer? Please explain.

9. Please provide any other comments you wish. Feel free to attach additional pages.

Name of person completing
this questionnaire:________________________________

Title:________________________________

Telephone No:________________ Fax No:________________

E-mail:________________________________

Postal Address:________________________________

Date:________________________________

Please complete and return before the end of July to: Stephen I. Erlichman, Fasken Campbell Godfrey, Toronto Dominion Bank Tower, Box 20, Suite 4200, Toronto-Dominion Centre, Toronto, ON, M5K 1N6. Telephone: (416) 865-4552 Fax: (416) 364-7813 E-mail: stephen_erlichman@fasken.com

# SCHEDULE B

## SUMMARY OF RESPONSES TO MUTUAL FUND GOVERNANCE QUESTIONNAIRE[1]

**1. (a) Does your organization have any mechanism in place (for example, a board of directors or advisory board for your mutual funds, or independent directors of the manager of your mutual funds) that has been established to deal with mutual fund governance issues?**

1. (a) Sixteen respondents stated that they had established a mechanism to deal with mutual fund governance issues. Four respondents stated that they had established no such mechanism.

**1. (b) If your answer to question 1(a) is yes:**
**(i) Please describe the mechanism and its mandate.**
**(ii) Has the mechanism been effective in fulfilling its mandate? Please explain.**

1(b)(i) Of the respondents that had established a mechanism to deal with mutual fund governance issues, four had established a board of governors/governance committee to oversee the mutual funds. Seven had instituted some form of independence requirement for members of their board of directors (whether the board of directors of the manager or a separate board to oversee the funds). One respondent had an employee dedicated to fund governance issues. Three organizations had boards of trustees (one having an independent majority and the others not). Finally, one respondent stated that its board of directors and audit committee acted as the funds' governance mechanism.

1(b)(ii) Of the respondents that had established a mechanism to deal with mutual fund governance issues, the vast majority (thirteen) stated that those mechanisms were effective. Two respondents stated that the mechanisms were effective, but qualified their affirmative responses. No respondents stated that their governance mechanisms were ineffective.

**1. (c) If you answer to question 1(a) is no:**
**(i) Have you considered adopting such a mechanism?**
**(ii) Why have you not adopted such a mechanism?**

1(c)(i) Of those respondents that had not adopted a governance mechanism, all four had considered adopting such a mechanism.

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1 The questionnaire was sent to all the mutual fund managers that are members of IFIC and also to all mutual fund managers that IFIC identified as not being its members. Twenty completed questionnaires, plus some other materials, were returned. In some cases, respondents did not answer all the questions so not all the summarized answers will reflect the same number of responses.

1(c)(ii) Respondents provided a variety of rationales for not adopting a governance mechanism, including:

- The difficulty of finding qualified individuals to serve;
- A lack of confidence in the effectiveness of adopting such a mechanism;
- Being new to the industry and not having had a chance to develop such a mechanism;
- The belief that the corporate governance model is inappropriate for mutual funds because it is premised on shareholder activism and shareholder activism is normally undertaken by large shareholders as opposed to mutual fund unitholders who typically hold small percentages of the fund;
- Being a no-load direct seller which does not have the same need for such a mechanism because there are fewer conflicts issues; and
- The belief that the U.S. style corporate governance model is inappropriate for Canada.

**2. Are there problems or issues in the Canadian mutual fund industry that you believe a mutual fund governance mechanism could solve or alleviate? If yes, please explain.**

2. A vast majority of the respondents (seventeen) answered yes, and provided explanations including the following:

- Investors should be provided the opportunity to question management in public;
- To deal with fund management problems;
- To consider such issues as the propriety of allocation of overhead costs to funds, policy development and the monitoring of fair pricing of securities and the responsibility for pricing errors;
- To deal with conflicts of interest and related party transactions in such a way as to allow the regulators to loosen the legislative restrictions on these matters;
- For investor protection; and
- To instill public confidence.

Two respondents answered no, with one explaining that such a mechanism would address only perceptions about the mutual fund industry, as substantive problems do not exist.

**3. Do you believe that a governance mechanism is necessary or is appropriate in the Canadian mutual fund industry? Please explain.**

3. Thirteen respondents answered yes and provided explanations including the following:

- To increase integrity in the mutual fund industry;
- To improve the public's perception of the mutual fund industry;
- To impose discipline in the mutual fund industry;
- The growth of the industry has not been matched by an increase in proper governance;
- To delineate the responsibilities of dealers and managers and to provide increased comfort levels to all the parties; and
- To balance the interests of unitholders and management.

Six respondents answered no, and provided explanations including the following:

- Governance can be addressed through existing regulations and industry guidelines; and
- The existing system is sufficient to deal with mutual fund governance.

Respondents who were both for and against instituting a governance mechanism in Canada raised concerns regarding balancing the costs and the benefits of any such mechanism and the possibility of regulatory overkill.

**4. Would your answer to question 3 change if one consequence of adopting a governance mechanism was that the existing conflicts regime for mutual funds in Canada was simplified?**

4. Seven respondents answered yes, six answered no and four answered maybe. In general, it is difficult to summarize the answers to this question because they are totally dependent on the answer to the preceding question and the indication of a "yes", "no" or "maybe" answer does not indicate a respondent's general disposition towards the imposition of a governance mechanism.

**5. If a governance regime is implemented in the Canadian mutual fund industry, do you have any thoughts on the type of regime that should be adopted? For example, should each mutual fund or each mutual fund family have a board of directors (of which a portion must consist of independent directors) or an advisory board, or should the manager of the mutual fund be required to have independent directors with a mandate to look out for the best interests of the unitholders of the mutual funds (rather than the shareholders of the manager)?**

5. Seven respondents were in favour of an advisory board. Three favoured an independent corporate style board of directors. Two favoured having either an independent board of trustees or independent directors on the manager's board. Five respondents thought it most appropriate to give mutual fund complexes the flexibility to choose their own governance mechanism.

**6. If a governance mechanism is implemented in the Canadian mutual fund industry, who should pay for the costs of the mechanism? Should the expenses be the responsibility of the mutual funds themselves (thereby passing the costs on to the unitholders) or of the manager?**

6. Thirteen respondents believe that such costs should be borne by the unitholders, many mentioning that it is appropriate given that the unitholders would benefit from the mechanism, that it is consistent with governance in other contexts and that it would clearly delineate that those providing the governance are to be responsible to those unitholders. One respondent stated that management should bear the costs. Two others noted that, as a practical matter, it made no difference, as all costs would be passed on to unitholders anyway.

**7. (a) Should mutual funds, their managers or their advisors be legally required to adopt and enforce codes of ethics designed to try to prevent activities that are unlawful or not in the best interests of the unitholders of the mutual funds?**

**(b) If your answer to question 7(a) is yes, who should monitor and enforce such codes?**

7. (a) and (b)

Twelve respondents answered yes and the most popular choice for the monitoring and enforcement of the code was management. After management, many respondents mentioned IFIC or the Mutual Fund Dealers Association of Canada and several also mentioned that auditors, securities regulators and governance boards could also have a role. Seven respondents answered no with the primary explanation that such a code would be superfluous.

**8. Should the company that manages a mutual fund be required to be registered with a securities commission even if the management company is not registered as an advisor or dealer? Please explain.**

8. Ten respondents answered yes. One respondent pointed out that this would correct the public's (incorrect) assumption that managers are already registrants. Several others stated that registration is necessary because it will lead to increased investor protection and it is important to have managers subject to increased regulation by the securities regulatory authorities. Four respondents answered no. Those who were against registration provided explanations including that it would offer no additional protection or benefit to unitholders, that registration would increase unitholder costs and that National Instrument 81-105 already provides for substantial obligations for industry participants without requiring registration.

## III. HISTORY OF THE MUTUAL FUND GOVERNANCE DEBATE IN CANADA

It is important to know the history of the debate surrounding mutual fund governance in Canada in order to understand that fund governance is a topic that has been considered in Canada for over thirty years and also in order to put into context the recommendations I am making in this report. Accordingly, in this section I will be reviewing the discussion about mutual fund governance that appears in the following documents:

1. The 1969 Provincial and Federal study entitled the "Report of the Canadian Committee on Mutual Funds and Investment Contracts"[1] (the "1969 Mutual Funds Report");

2. The 1974 "Proposals for a Mutual Fund Law for Canada"[2] (the "1974 Proposals");

3. The short paper I prepared in 1993 entitled "Managing Potential Conflicts of Interest"[3] (the "Conflicts Paper");

4. The January 1995 Report of Glorianne Stromberg entitled "Regulatory Strategies for the Mid-'90s: Recommendations for Regulating Investment Funds in Canada"[4] (the "Stromberg Report");

5. The November 1996 Report of the Investment Funds Steering Group entitled "The Stromberg Report: An Industry Perspective"[5] (the "Steering Group Report");

6. The January 1997 Report of the Consultative Committee on the Regulation of Mutual Funds entitled "The Modernization of the Normative Framework in the Quebec Context"[6] (the "Quebec Report");

7. The October 1998 Report by Glorianne Stromberg entitled "Investment Funds in Canada and Consumer Protection: Strategies for the Millennium"[7] (the "Second Stromberg Report"); and

8. The November 1998 Report of the Standing Senate Committee on Banking, Trade and Commerce entitled "The Governance Practices of Institutional Investors"[8] (the "Senate Committee Report").

I will discuss each of these documents in chronological order.

**1. The 1969 Mutual Funds Report**

This extensive work of over 800 pages forms the basis of mutual fund regulation in Canada today. The Committee that made this report (consisting of Messrs. Gordon Grundy, Louis de B. Gravel, William Irwin, Marc Lalonde, Kenneth Lawton and Harry Rose, with the assistance of James Baillie, Claude Bruneau and various research staff and consultants) was responsible for presenting recommendations to all the ten provinces and the federal government concerning the legislation and regulations to be implemented in order to regulate mutual funds across Canada. According to the 1969 Mutual Funds Report, the creation of the Committee was a result of a number of factors, most of which related to the spectacular growth of mutual funds in Canada at the time. The preface to the report also indicated as follows:

> "From a regulatory standpoint, the interest was accentuated by awareness that mutual funds were subject to a variety of legislation, most of it not specifically tailored for them and much of it difficult to apply to them. There was also concern with the lack of regulatory provisions designed to deal with problems involved in the increasing tendency of other financial institutions to issue instruments competitive with those issued by mutual funds. …
>
> Another factor which encouraged the creation of the Committee was the publication in March 1965 of the report of the Attorney General's Committee on Securities Legislation in Ontario. Appendix "D" to that Report indicated that a number of submissions concerning mutual funds had been received but concluded that an adequate study of mutual funds would have to extend to other financial institutions issuing similar or competitive instruments. A separate study for this purpose was recommended."[9]

The foregoing sets out the context in which the 1969 Mutual Funds Report was prepared. Given the importance of the report, the fact that, based on my experience, very few people involved in the Canadian mutual fund industry today know of the existence or, more importantly, the contents of the report, and the fact that the report discussed in detail different mutual fund governance mechanisms, I will quote large extracts from Chapter VI of the 1969 Mutual Funds Report entitled "The Relationship between Mutual Fund Investors and Management". Chapter VI of that report discusses the thoughts and processes behind the recommendations made by the Committee with respect to the governance of mutual funds.

"6.01 During the course of our work we have been struck by the lack of consensus within the mutual fund industry, and among regulators and commentators, as to the nature of the relationship between the mutual fund, its investors, and its management company. The two prevalent philosophies are alluded to in paragraph 4.12. On the one hand, many considered the mutual fund to be simply the method by which the management company provides the service of investment management for those prepared to entrust their money to it. On the other hand, it is often regarded as an enterprise, separate from the management company, that consists of an investment portfolio operated for the benefit of its participants; those who accept this philosophy acknowledge that the management company has the right to provide investment advice and administrative services, but emphasized that the right is only contractual and if it renders poor service the management company can be dismissed and replaced with a successor selected by the mutual fund. …Under the first philosophy, then, the person who invests in a mutual fund through purchase of its shares or units is considered to purchase the right to have his money managed by the management company; under the second, he is considered to acquire an interest in a separate enterprise which has a terminable contract with the management company.

6.02 The Canadian mutual fund industry includes mutual funds that seem to exemplify each of the two philosophies as to relationships between mutual funds and their management companies. …

6.04 The two philosophies of relationships between the mutual fund and its management company are logically irreconcilable, and it is important to consider their relative merits in the formulation of a regulatory scheme. The first of the two philosophies seems to us to accord more closely with the realities of the situation. We viewed the mutual fund investor as a person who wishes to delegate the management of his money, and we think that those who consider the question at all would see the delegation as being to the management company. …As a practical matter, and regardless of the legal forms used, mutual funds rarely, if ever, function as entities separate from their management companies. …

6.05 Our belief that the mutual fund is the method whereby the management company provides the service of investment management to investors is relevant in the determination of our approach to regulations. It accentuates the importance of the management company's position. If the mutual fund were an independent entity which negotiated with the management company to obtain investment advice for a fee, those responsible for the operations of that independent entity might be expected to take appropriate precautions in order to protect the assets of the mutual fund. In fact, such precautions must be taken by the management company.

6.06 If a mutual fund investor considered the risks he was prepared to accept in his investment, the only one he would consciously accept would be that his money might be partially or wholly lost as a result of a market decline or of investment decisions which turned out to be mistaken although made in good faith. He would not be prepared to accept the risk of investment decisions made in bad faith for purposes other than the good of the mutual funds; of theft; or of loss through bankruptcy or other misadventure which affects his salesman or anybody else who handled his money before it reaches the mutual fund. More precisely, he would wish to assume that such risks had been reduced to the minimum by appropriate precautions designed to prevent their occurrence. In our view, requirements to ensure that such precautions are taken form a necessary part of any regulatory scheme designed to provide protection for the mutual fund investor.

6.07 The risks referred to in the preceding paragraph result from various possibilities. Through no fault of the responsible persons, the mutual fund, management company or distribution company could encounter financial misfortune, thereby preventing fulfilment of their obligations and exposing the shareholders or unitholders to the possibility of serious loss. Alternatively, those persons with access to assets of the mutual fund might embezzle them, or the assets could be lost through theft or by fire. *Finally, persons with the power to control investment decisions affecting the mutual fund might make those decisions so as to favour their own interests rather than the best interests of the mutual fund.*

6.08 It could be said that the risks described in the preceding paragraph are associated with the separation of ownership from management and are present to some extent with any public company managed by persons who do not also own it. In light of this, the contention could be made that it would be inappropriate to deal with such risks only in the context of mutual funds, without also dealing with them in the context of public companies generally. By equating the mutual fund with an integrated public company, that contention impliedly accepts the second of the two philosophies described earlier in this chapter, and is therefore not in accord with our belief that the mutual fund is used by the management company to provide the service of investment management. *The divorce between ownership and management is more complete in the mutual fund context than with other public companies, for the mutual fund participant has no voice at all in the affairs of the management company.* This alone would provide adequate reason for rejection of the contention described above. That contention should also be rejected because *mutual funds are* *financial institutions, and governmental controls to prevent misuse of assets have traditionally been more rigorous with financial institutions than with other public enterprises.*

6.09 *The best protection against the types of risks here being considered would be an arrangement whereby the management company and the distribution company were subjected to continuing independent scrutiny over their operations. The scrutiny might be provided by the mutual fund investors, or by a surrogate acting on their behalf; what is essential is that the procedure used be effective but not interfere unduly with the freedom of management to make investment decisions. Such an objective is obviously difficult to attain in a workable fashion, but a number of techniques have been proposed for the purpose. This chapter is devoted to a consideration of those techniques. Some of them are inconsistent with our view that the mutual fund is used by the management company to provide the service of investment management. We are not deterred by that fact from considering them on their merits; if satisfied that a technique would effectively provide continuing scrutiny and was workable, we would recommend its adoption in spite of a philosophical inconsistency.*

6.10 An important matter for consideration in connection with continuing scrutiny, as with most of the questions considered in this report, is disclosure. It has been well said that sunlight is the best of disinfectants and electric light the best policeman, and it may be asked why disclosure is not alone sufficient for the provision of continuing scrutiny. … There are two reasons why we do not consider disclosure as sufficient of itself to provide continuing scrutiny over management. The first is the practical impossibility of providing comprehensive information as to all transactions on a clear and understandable basis at reasonable costs. … The second is that *disclosure alone is of little or no value unless there is some independent person in a position such that he has not only power but also motivation or responsibility to take appropriate action to resolve abuses that are disclosed. This condition is not easily satisfied*, and much of the following discussion is concerned with it."[10] [emphasis added]

The 1969 Mutual Funds Report then went on to consider various techniques to provide continuing scrutiny over mutual fund management. The techniques described in the 1969 Mutual Funds Report were: (i) the availability of the right to redeem; (ii) independent directors; (iii) voting rights; (iv) independent trustees with supervisory powers; (v) the auditor; and (vi) internalization of the management and sales functions. I will quote from each of these topics discussed in the 1969 Mutual Funds Report and particularly in detail from the sections dealing with independent directors.

**(a) The Availability of the Right to Redeem**

On this topic, the 1969 Mutual Funds Report began as follows:

> "6.23 It is frequently stated by members of the mutual fund industry that the best continuing control over their practices, apart from their own abilities and standards, is the possibility that annoyed shareholders or unitholders might vote with their feet by presenting their shares or units for redemption. … We accept that in extreme cases it might be an effective protection against abuses, but for a number of reasons we have concluded that reliance cannot feasibly be placed upon it to provide the type of continuing scrutiny that we feel to be desirable."[11]

The 1969 Mutual Funds Report then listed various problems that the Committee saw with relying upon the right to redeem as the method of providing scrutiny over management of mutual funds. These problems included the following:

(a) redemption by dissatisfied securityholders is likely to be less effective as a control over management than would be their active involvement as continuing voting securityholders;[12]

(b) mutual fund securityholders do not possess the ability and knowledge necessary to conduct a continuing review of management's activities in order to make an informed decision as to whether to redeem;[13]

(c) mutual fund securityholders generally are unwilling or unable to actively participate in the management of their own investments and therefore it is unlikely that many of them would expend the time and effort necessary to complete a review of materials sent to them to ensure that management was paying proper attention to its responsibilities;[14] and

(d) a dissatisfied mutual fund securityholder often will not exercise his right to redeem without hesitation because he is often in a position where he will suffer a significant loss if he redeems.[15]

Accordingly, the 1969 Mutual Funds Report concluded that "while emphasis should be placed on the importance of disclosure, it should not be assumed that disclosure coupled with the availability of the right to redeem will provide adequate continuing scrutiny over the management of mutual funds".[16]

**(b) Independent Directors**

The 1969 Mutual Funds Report then discussed the possibility of mandating independent directors for mutual funds. I quote in detail from this section of the 1969 Mutual Funds Report.

> "6.31 … It is, then, appropriate to consider whether a surrogate can be relied upon for the provisions of continuing scrutiny. In this section we consider the most oft-suggested surrogate, members of mutual fund boards of directors who are unaffiliated with management; later in this chapter we discuss the extent to which an independent trustee, or the mutual fund auditor, should be relied upon to fulfil the role of surrogate.

6.32 *In the consideration of independent directors, the question we must resolve is not whether they are desirable but whether they should be imposed on the mutual fund industry by legislative fiat.* The very existence of a separate board of directors for the mutual fund may seem inconsistent with the philosophy of the mutual fund as the method whereby the management company sells investment management. The inconsistency is, however, more apparent than actual in view of the wide scope of powers entrusted to the management company under the management contract, and the even wider powers ordinarily exercised by it in practice. In addition, *we think that there are certain obvious advantages to a mutual fund and its shareholders in a board of directors that includes at least some members who are independent of management. These members can assist management by subjecting its decisions to informed and impartial review, perhaps with the additional benefit of comments based on backgrounds in other business activities. It can protect shareholders or unitholders by ensuring that management properly performs the duties for which it is paid. For all these reasons, we support the use of independent directors on a voluntary basis by mutual funds. This does not resolve whether their use should be required.*

6.33 In the United States, Congress has decided that the advantages of independent directors are so significant as to justify the imposition of a statutory requirement. …

6.34 There is presently no Canadian legislation equivalent to the 1940 Act requirement referred to in the preceding paragraph. …

6.37 The imposition of a statutory provision for the independence of a specified percentage of mutual fund boards of directors involves two requirements: that each mutual fund must have a board of directors, and that a specified percentage of the members of each board must be independent of management. Serious difficulties arise in the application of each requirement. Some indication of the nature of these difficulties may be gained from developments in the United States. …

6.41 *We think three conclusions can fairly be drawn with respect to the concept of independent directors on the basis of the experience described above. First, the use of independent directors in the United States has not resolved the problems inherent in the separation of management from ownership in the context of mutual funds. Second, it is clear that independent directors have not been able to deal adequately with the matters regarded by the S.E.C. as major problem areas, mentioned in the quotation in paragraph 6.38* [i.e., management compensation, allocation of brokerage and the setting of sales load levels]. *Third, it seems apparent* *on the basis of experience both in Canada and in the United States that any effective requirement for the independence of directors would have to include a very wide and vigorous test of independence.* …

6.42 Difficulties in the application of a requirement for independence of directors would arise not only with the criteria for independence, but also with the necessary second branch of the requirement, that each mutual fund must have a board of directors. … These problems are not insuperable; *a requirement that there be a board of directors for every mutual fund could be successfully enforced. However we hesitate to recommend the imposition of the requirement unless satisfied that the results would be beneficial. We are not so satisfied.*

6.43 Apart from the problems shown by experience to exist, *we are concerned with a question of principle inherent in the application of a requirement for the independence of directors. We question whether government should require that persons without a direct stake in the success of the operation be put in a position where they are expected to pass on the business judgment of the management company*. This point of principle serves to fortify us in a decision that would in any event be dictated by the other considerations discussed above.

6.44 *For the reasons set out in this section, we have concluded that there should be no statutory requirement that each mutual fund have a board of directors or equivalent body, and no statutory requirement that a specified percentage of the members of such bodies be independent of management. This conclusion is not relevant to the establishment of such arrangements on a voluntary basis or through self-regulation, developments which we think desirable*."[17] [emphasis added]

I will address in the recommendations section of this report my responses to the reasons given by the authors of the 1969 Mutual Funds Report for not mandating an independent board of directors or an equivalent body for mutual funds. Suffice it to say at present, however, that the 1969 Mutual Funds Report clearly indicated that the Committee supported the use of independent directors, on a voluntary basis, by mutual funds but it was not willing to recommend the statutory imposition of such a requirement because the Committee was not satisfied that the results would be beneficial.

**(c) Voting Rights**

The 1969 Mutual Funds Report then discussed whether voting rights should be provided to securityholders of mutual funds as a mechanism to provide scrutiny over management of the funds. Extracts from the 1969 Mutual Funds Report follow.

> "6.45 Perhaps the most important right accorded shareholders under most corporations acts is the right to vote. It is through this right that shareholders, at least in theory, are intended to exercise continuing control over management; the right is also of indirect value in the provision of continuing scrutiny, since information must be supplied to shareholders so that they can consider the matters upon which they are expected to vote. …
>
> 6.49 The question whether shareholders or unitholders should be accorded by statute the power to vote for the election or approval of management has caused us considerable concern. As with independent directors, the problem is not whether the arrangement would be desirable but whether it should be required by legislative fiat. …
>
> 6.50 In the United States, the Investment Company Act of 1940 requires that the management contract be submitted to the holders of shares or units for their approval at least once every two years. …
>
> 6.51 … we have concluded that a requirement similar to the 1940 Act provision described above should be adopted for application to Canadian mutual funds. In our opinion, it is reasonable that management should make an accounting to shareholders or unitholders at least once in every two years. Such a procedure will provide a method for dismissal of management in a very serious case, and its value will be established if it ever facilitates the dismissal of an inefficient management company. This emphasis on the management contract will be consistent with the procedures of mutual funds whether or not they have boards of directors; a mutual fund which

has a board of directors can deal with the election of directors and the approval of the management contract at the same meeting. …

6.54 It is also relevant that votes for the approval of actions proposed by management are fully consistent with the philosophy that the mutual fund is the method whereby the management company sells its investment advice. A change in the terms upon which the investment advice is provided should be approved by those affected. …

6.55 We have concluded that votes of shareholders or unitholders should be required for the approval of certain types of actions that may be proposed by management. The actions for which we think this treatment should be provided are somewhat different from the types of actions usually so treated under corporate law, because of the differences in the mode of operation of mutual funds. Only a few types of actions should, we feel, fall within this category. They are merely listed here, and are discussed in detail in the indicated paragraphs elsewhere in this report. The following actions are included: material amendments to the management or distribution contract …, or to the statement of investment objectives and practices …; transfer of the management contract …; and where required by the appropriate administrator, the dismissal of the mutual fund auditor …, and amendments to the agreement for custody of assets of the mutual fund. …Each type of action should be prohibited unless the approval, in writing or at a meeting, of the holders of a specified percentage of outstanding shares or units as at [a] certain record date is obtained. Implementation of this requirement would provide shareholders or unitholders with significant protection against material changes in the method of operation of the mutual fund.

6.56 …In our opinion, adequate protection against major adverse actions by management would be provided by the voting rights proposed earlier in this section, and little would be added to the quality of available protection by permitting votes to be initiated by shareholders or unitholders. We have therefore concluded that provision for holders of shares or units to call for votes on specified matters without prior action by management are unnecessary. …”[18]

**(d) Independent Trustees with Supervisory Powers**

At this point the 1969 Mutual Funds Report discussed whether the use of independent trustees rather than independent directors should be mandated. Relevant extracts from the 1969 Mutual Funds Report follow below.

> "6.60 … The regulations applicable in Great Britain to unit trusts, the equivalent of mutual funds, rely on a trustee for that purpose [i.e., acting as surrogates on behalf of mutual fund investors]. The responsibilities of this trustee go beyond those of a custodian, for a custodian is ordinarily responsible only to confirm that the organization for which it acts actually possesses the assets it claims to own; the trustee of a unit trust must not only do this but must also review investments made by the unit trust to ensure that they meet certain standards. … [T]he responsibilities held by the trustee of a unit trust are summarized in the following quotation from an English text:
>
> > … Trustees of British unit trusts have many other duties to perform; in general they are watchdogs of the unit holders, and make sure that the provisions of the trust deed and the provisions of the Prevention of Frauds (Investment) Act, 1958, as implemented by the Board of Trade regulations, are not violated. Depending upon the provisions of the trust deed, the main duties of trustees are: to buy and sell underlying securities on instruction from the management, but to veto investments if not permitted by the deed, or if they consider them not to be in the best interests of the unit holders; to see that distributions are not inflated by underlying securities always being bought cum dividend and sold ex dividend; to receive the income of the fund and distribute it to the unit holders; to maintain and keep up to date a register of unit holders; to see that no certificate of units is issued before they are possessed of equivalent asset value; to take steps to remove management from office on good cause; and to be satisfied with sales promotion literature before it is used. All these duties are not necessarily assumed by all trustees, and all trustees probably try to keep their responsibilities down to a minimum. The trustees in Britain are mostly high quality banks, especially the Big Five, and high class insurance companies. They receive fees for their services which are normally paid out of the gross remuneration of managements. …

6.61 It is of interest that reliance on a trustee as described in the above quotation, unlike the use of independent directors, is fully consistent with the philosophy that the mutual fund is the method whereby the management company sells its investment advice. It is also important to note that the incorporation into the regulatory structure of requirements such as described in the quotation would be a decision with implications at least as far-reaching as reliance on independent directors. It would go far beyond the narrow question of custody of assets… . If successfully implemented, the use of independent trustees would resolve the principal problems inherent in the separation of management from ownership in the context of mutual funds.

6.62 We were attracted for a number of reasons by the use of independent trustees to scrutinize the operations of mutual funds. …

6.64 In spite of the advantages to be gained through adoption of the procedure followed in Great Britain, we have concluded that its adoption in Canada would not be feasible. This conclusion is attributable to several factors, of which the first is that of cost. The initial costs in particular would be substantial for those mutual funds required to make the changes in their methods of operation… . The substantial increase in the extent of the obligations of trustees would result in a commensurate increase in their costs and the fees they would charge for their services. The increased costs would inevitably be paid, directly or indirectly, by mutual fund participants.

6.65 The second difficulty lies in the determination of what organizations would be permitted to assume the responsibility of trustees under the proposed procedure. … It is clear to us that the selection of a trustee would have to be approved by the appropriate administrator, not only to ensure its competence but to verify that it was in fact in an arm's length relationship with the mutual fund and the management company. Such decisions would be of considerable difficulty, and to the extent that reliance is placed on the trustee in the regulatory structure the participants in the mutual fund might suffer as a result of use of an inappropriate trustee . …

6.66 Another problem with the proposed procedure lies in the competitive anomalies that would result from its introduction. The most obvious example, but far from the only one, is that decisions concerning a trust company investment fund would be scrutinized by a trust company other than the one responsible for its organization. …

6.67 Finally, we are troubled in this context as with independent directors by the point of principle described in paragraph 6.43. Independent trustees, like independent directors, would be persons without a direct stake in the success of the enterprise who would be expected to pass on the business judgment of the management company. We hesitate to recommend a requirement with such a result. For this and the other reasons set out above, we have concluded against a recommendation in favour of Canadian adoption of a requirement similar to that described in the quotation in paragraph 6.60.

6.68 For the reasons set out in this section, we have concluded that there should be no statutory requirement in Canada for an independent trustee with supervisory powers to be associated with each mutual fund… ."[19]

**(e) The Auditor**

The 1969 Mutual Funds Report then discussed the role of the auditor. The following are the relevant provisions from this section of the 1969 Mutual Funds Report.

"6.69 …While the mutual fund auditor cannot assume the scope of responsibility that could be exercised by a director or trustee, his role can be of great importance. In this section we discuss the extent to which reliance can appropriately be placed on him to provide continuing scrutiny in the absence of an effective surrogate for that purpose. …

6.70 The position of the auditor as the only 'outsider' who is in a position to conduct a complete review of the records, accounts and procedures of the mutual fund and of related records of the management and distribution companies makes it inevitable that he should be relied on as an essential element of the regulatory structure. There are, however, two important limitations on the extent to which he can provide continuing scrutiny of operations. The first is inherent in the nature of his duties. His responsibility is to verify the financial position of the mutual fund at regular intervals, usually annual, and to provide other reports on specified matters at certain times. This means that it would not be feasible to expect him to review each transaction as it occurs. It also means that he cannot be expected to undertake such continuing responsibilities as those of custodian.

6.71 The second limitation on the responsibilities that can be entrusted to the auditor flows from the traditional concept of his function. Auditors are not ordinarily expected to make business judgments. … As a result, it would be a novel extension of an auditor's responsibilities to require that he makes decisions similar to those entrusted to independent trustees in Great Britain or to independent directors in the United States. Unlike independent directors or independent trustees, the auditor does not 'second guess' management decisions; he only reports on them.

6.72 In spite of the importance of the two limitations described in the preceding two paragraphs, there is still very considerable scope for the allocation of responsibilities to the auditor. …

6.80 The prime responsibility of a mutual fund auditor should, we feel, be to its shareholders or unitholders. This is of even greater importance in the context of mutual funds than of commercial companies. We have concluded that this responsibility is appropriately recognized by a requirement that auditors' reports be addressed to the shareholders or unitholders, as well as to the directors or other appropriate authority. This will serve to emphasize the fact that in his review of his mutual fund accounts the auditor acts as a surrogate on behalf of the shareholders or unitholders. …

6.88 For the reasons set out in this section, we recommend …

*(11)* *that the auditor should be permitted, but not required, to include in the report referred to in recommendation (5)* [i.e., the auditor's report that accompanies the financial statements of the mutual fund that are included in the annual report and prospectus] *a reference to any matters which have come to his notice that, in his opinion, constitute evidence of violations of law or are otherwise improper, although they do not materially affect the financial statements*;

*(12)* *that the auditor should be required to report to the appropriate administrator any matters which come to his notice that, in his opinion, do or might constitute evidence of violations of law, and should be permitted so to report any evidence of matters that he regards as improper… .*"[20] [emphasis added]

**(f) Internalization of the Management and Sales Functions**

The 1969 Mutual Funds Report finally discussed internalization of the management and sales functions as a possible way to scrutinize management. In this regard, the 1969 Mutual Funds Report stated as follows:

> "6.89 The comment is sometimes made that many of the problems of the mutual fund industry are attributable to the separation from the mutual fund of the management and sales functions, and could be resolved if they were performed by the mutual fund itself through its employees. The need for scrutiny of management is only one of the problems that, it is said, would be resolved by compulsory internalization of the management and sales functions… .
>
> 6.91 … We can see no logical reason to assume that the need for continuing scrutiny of management would be any less or any greater if these functions were internalized. A salaried employee who is not subjected to continuing scrutiny is at least as susceptible to conflicts of interests as an outside organization compensated on a fee basis and not subjected to continuing scrutiny. It is the separation of ownership from management which causes any problems that exist, not the segregation of functions. …
>
> 6.95 For the reasons set out in this section, we have concluded that no attempt should be made to require compulsory internalization of the management and sales functions in the Canadian mutual fund industry."[21]

After completing its discussion on mutual fund governance, the 1969 Mutual Funds Report then focused on registration requirements for participants in the mutual fund industry. In this regard, the 1969 Mutual Funds Report stated as follows:

> "7.01 …While implementation of the recommendations made in Chapter VI would, we believe, contribute significantly to the quality of investor protection, *none of those recommendations would provide the continuing scrutiny which we think desirable. It is therefore necessary to consider in detail what legislative requirements would provide adequate protection*

*against the types of risk that might otherwise be dealt with through continuing independent scrutiny of management*.

7.02 The discussion in paragraphs in 6.04 to 6.09 is premised on our assumption that the only risk the mutual fund investor would be prepared, or should be expected, to accept are those attributable to investment decisions which proved to be mistaken although made in good faith. The other risks discussed in those paragraphs do not fall within this category, and appropriate procedures or requirements should be established to reduce or eliminate the degree of exposure to these risks. All are attributable either to the possibility of dishonesty or bad faith on the part of persons concerned with the operation of the mutual fund, or to the possibility that financial difficulties might be encountered for reasons other than dishonesty or bad faith, or mistaken investment decisions made in good faith.

7.03 It is apparent that the exposure to risks of the type described in the preceding paragraph could be reduced or eliminated if participation in the mutual fund industry were restricted to honest and ethical men of good financial standing and ability. …

7.08 One of the principal themes which pervades this report is that the mutual fund, its management company and its distribution company should be treated as a single organization for regulatory purposes although they are technically separate entities. …[T]he management company need not register if it is a separate entity from the distribution company; at December 31, 1967, this was true of 27 of the 84 management companies of mutual funds qualified for sale in Canada.

7.09 The filing and registration requirements presently applied under Canadian securities legislation are designed to facilitate controls over the sale to the public of securities. …As financial institutions to which members of the public confide their savings dollars, controls over mutual funds applied for the protection of the investor should not be dependent upon whether their shares or units are currently in the course of public distribution. Nor should the management company be immune from regulations because it is a separate entity from the distribution company. *We have therefore concluded that if a mutual fund is operating within the relevant jurisdiction at the effective date of the legislation, or thereafter commences to operate in that jurisdiction, that mutual fund, its management company and its distribution company should all be required to become registered with the appropriate administrator*. …"[22] [emphasis added]

The recommendation that mutual fund managers be required to register with a securities regulator, irrespective of whether it functions as an adviser or dealer, has not been implemented in Canada.

## 2. The 1974 Proposals

The preface to the 1974 Proposals described the mandate of the two individuals (Messrs. Warren Grover and James Baillie) who drafted this document. I quote from the preface:

> "When we were requested by the Department of Consumer and Corporate Affairs to prepare this report, only one guideline was given to us. We were to endeavour to arrive at a draft statute that would reflect the best of current knowledge and practice in the area and would also reflect the distinctive needs of the Canadian market and economy. In doing so, we were to draw on the recommendations made in the 1969 Report of the federal-provincial Canadian Committee on Mutual Funds and Investment Contracts, often called the Mutual Fund Report, but we were also to take into account legislative experience and developments in other countries."[23]

The authors then stated the following in the introduction to their proposals:

> "Canadian mutual funds are currently regulated at the federal level only through general corporate and tax legislation and at the provincial level through general corporate and securities legislation. Yet all of the considerations which support detailed regulation of other financial intermediaries are of at least equal relevance to mutual funds. Certain distinctive features of the industry strengthen the case supporting legislation tailored for it. Mutual funds are the only major intermediary oriented almost exclusively to equity investments. Their distribution arrangements are designed to enable them to provide investment opportunities on an economic basis to persons with very few dollars to invest and who might otherwise be unable to participate in the equity markets. Their shares are sold in large part through the use of techniques designed to bring them to the attention of

> such persons. All of these characteristics underscore the scope of the abuses that could be perpetrated by unethical participants in the industry. …
>
> While the detailed recommendations reflected in the proposed statute deviate in many particulars from the Mutual Fund Report, its general approach is the pragmatic one adopted by the Report. The mutual fund is regarded as a vehicle for the pooling of investments made by a number of investors in a single portfolio under common management, from which each investor may withdraw his proportionate share on demand. So regarded, the mutual fund is merely a tool to provide combined investment management. Acceptance of this approach affects many aspects of the legislative pattern. For example, it indicates that except in special circumstances the mutual fund should not be treated as a separate entity from its investment manager, requiring a separate board of directors. We have endeavoured to accept the implications of this underlying philosophy in the formulation of the rules in the proposed statute."[24]

The 1974 Proposals did not focus in any detail on the issue of mutual fund governance. There were various matters in the commentary to the proposals, however, which referred to mutual fund governance, some of which are set out below:

> "5.03 Voting Rights
>
> Corporate law traditionally places considerable responsibility on the directors and requires that they be elected by shareholders. With mutual funds, this situation is often different. Many trusteed funds have no equivalent to a board of directors. With incorporated funds, the board of directors often does little beyond ratifying decisions of the management company and is in some cases elected by the management company through ownership by it of the only issued class of voting shares. The Mutual Fund Report S.6.45 – 6.49 sets forth in some detail the reasons why the existing practice should be allowed to continue and we have accepted the arguments advanced there. We also concur, however, with the suggestions in S.6.59 of the Mutual Fund Report that voting on management changes and changes in investment objectives or practices should be subject to shareholder ratification. Our proposals differ from the Mutual Fund Report in containing no requirement for shareholder approval of the renewal of the existing management contract every 2 years as we feel it would be a hollow right, putting the complex to unnecessary expense to call the meeting. The real protection is to permit shareholders to require a change of investment management, to require that their approval be obtained for an assignment of the management contract, and to

> give the administrator power to ensure that the management fees charged do not exceed what is reasonable."[25]

With respect to whether a mutual fund manager should be registered, the 1974 Proposals stated as follows:

> "2.04 Registration of Management and Distribution Companies
>
> If the Act is to regulate mutual funds it must also regulate their management and distribution functions. As these are carried on in separate entities in the usual case it is necessary for the management companies and the distribution companies to register. Accordingly, *these proposals envisage the registration or licensing of each part of the mutual fund complex… .*"[26] [emphasis added]

The 1974 Proposals also set out a proposed standard of care and duty of loyalty for the manager in section 7.07(1) of the draft statute:

> "Every person responsible for the management of a mutual fund … shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the mutual fund, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances."[27]

It is interesting to note that the foregoing standard of care is the same as that currently set out in subsection 116(1) of the *Securities Act*[28] (Ontario). Under this standard, it would appear that the persons managing a mutual fund must act in the best interests of the mutual fund notwithstanding that such persons also may have a conflicting duty to the manager's shareholders at common law or under the corporate statute governing the manager.

An important right recommended in the 1974 Proposals relates to the nomination of a new management company. In a relevant part, the 1974 Proposals stated as follows:

> "8.02 Nomination of New Management Company
>
> …We also propose, as was suggested by the Mutual Fund Report S.11.38, that a shareholder can nominate an alternative to the incumbent management company. This would be an important new right of the mutual fund shareholder, the reasons for which are set out in the Mutual Fund Report in S.11.28 – 11.37.
>
> After such a nomination there will be two potential managers with two management contracts which may have significant differences between them. The mutual fund shareholders will then be able to exercise a choice. Obviously under this procedure a prospective alternate – perhaps a competing management company – would be able to have a friendly interest purchase a share and nominate the alternate. The result could be considerable competition for management contracts, a prospect we view as salutory so long as the fund is not forced to bear the costs of several proxy solicitations. We believe that mutual fund investors purchase their shares on the basis of the existing management. It would follow that the insurgent should only be successful if true dissatisfaction with the incumbent is apparent. To guard against the possibility of needless competition the proposals provide that the insurgent will have to bear his own costs. In addition, the incumbent can only be removed if two-thirds of the votes cast are in favour of removal. …This novel remedy, proposed in the Mutual Fund Report, is, we feel, worth trying. It must be kept under review."[29]

This proposed right of shareholders to nominate a new management company was never implemented in Canada.

## 3. Conflicts Paper

The previous two sections reviewed in detail the deliberations relating to mutual fund governance from the late 1960's and early 1970's. There seems to have been little public debate about mutual fund governance in Canada during the rest of the 1970's and in the 1980's. It appears that in Canada the debate recommenced around 1993, the year in which I presented a paper entitled "Managing Potential Conflicts of Interest" at a mutual funds conference in Toronto. What was interesting to me when I conducted my research for that paper was that very little had been written relating to conflicts of interest and governance with respect to Canadian mutual funds since the 1969 Mutual Funds Report and the 1974 Proposals. The focus of my 1993 paper was managing potential conflicts of interest within the Canadian mutual fund structure and I suggested that it might be time to consider a mutual fund governance regime having as its basis independent directors as a possible solution to the conflict issues. Let me quote the conclusion of my 1993 paper.

> "I am not suggesting that anything untoward is occurring within mutual fund organizations today in the context of conflicts of interest. It is possible, however, that persons running various mutual fund organizations have not spent much time thinking about potential conflicts of interest and what is the best way to resolve them. If a conflict has not been identified in the first place, it obviously cannot be resolved. To the extent that the Canadian securities authorities have identified potential conflicts of interest, they have taken various routes depending upon the nature of the conflict. These routes include (i) requiring disclosure of the potential conflicts (for example, the previously mentioned prospectus disclosure required by National Policy No. 36 of conflicts of interest or potential conflicts of interest between the issuer and the manager, investment adviser and possibly the trustee, and the requirements in the same policy to give particulars of any other material facts relating to the securities proposed to be offered which are not contained in the annual information form), (ii) prohibiting the transaction (such as the prohibition on reimbursement of organization costs of a mutual fund), (iii) prohibiting the transaction unless it is approved either by securityholders or by the Canadian securities authorities or both (such as the requirement for securities authorities' approval relating to fund on fund investments), (iv) permitting the transaction to proceed without any required disclosure or approval (such as the allocation of the manager's marketing budget), or (v) permitting the use of 'Chinese walls' (for example, when the manager has inside information).
>
> The regulation of mutual funds today, including the regulation of some of the foregoing potential conflicts of interest, was addressed in detail in the 1969

Mutual Funds Report and in the 1974 Proposals for a Mutual Fund Law for Canada. As far as I am aware, the operations of Canadian mutual funds in the 25 years since the 1969 Mutual Funds Report have not resulted in any major abusive transactions coming to light.

Accordingly, if one subscribes to the 'if it ain't broke, don't fix it' theory, one could advocate continuing to rely upon the existing rules and existing remedies for breach of the rules. Under this scenario one would continue to rely on the fiduciary obligations of the trustees, managers, investment advisers, on the restrictions set out in the *Securities Act* (Ontario) and other securities legislation across the country and in National Policy No. 39, on the disclosure required in prospectuses and annual information forms by National Policy No. 36, National Policy No. 39 and securities legislation and on the remedies available upon abuse, namely the power of the regulatory authorities such as the Ontario Securities Commission to investigate alleged problems and to issue orders (such as cease trading orders), to levy fines or not to issue receipts for prospectuses thereby not permitting renewals of fund prospectuses, and the power of securityholders to commence litigation if they cannot otherwise obtain an adequate remedy.

Another line of thought follows the premise that certain actions may have gone on for many years in the mutual fund industry, and may still be going on, which have not been brought to light because the disclosure requirements are not sufficient or, if adequate, are not followed. In addition, one may argue that the securityholder approval requirements are not very effective as many securityholders do not understand what they are asked to approve and, in the vast majority of cases, securityholders approve almost anything that the manager of a mutual fund is asking them to vote on. If one follows this school of thought, then one might consider requiring independent informed persons to monitor conflicts of interest and, in some cases, to approve conflicts of interest. For example, the *Investment Company Act* in the United States has, among other things, the following requirements to monitor or approve possible conflicts: (i) a board of directors, 40% of whom must be independent, whose function is to oversee the operations of the mutual fund and to police conflicts of interest; and (ii) shareholder voting to, among other things, elect board members, approve or disapprove fee arrangements, and accept or reject changes in a mutual fund's investment policies. These requirements were reviewed in the 1969 Mutual Funds Report and also in the 1974 Proposals for a Mutual Fund Law for Canada and were rejected for Canadian mutual funds. It is interesting to note that in the 1992 United States Securities and Exchange Commission staff report entitled Protecting Investors: A Half Century of Investment Company Regulation, the staff of the Securities and Exchange Commission recommended that the 40% independent director requirement be increased to in excess of 50%. Staff also recommended that independent director vacancies be filled by persons chosen by the remaining independent directors and that independent directors be given express authority to terminate advisory contracts. In light of the 1992 study by the United States

Securities and Exchange Commission and the 25 years which have elapsed since the 1969 Mutual Funds Report, is it time to re-examine potential conflicts of interest in the mutual fund structure and the possible role of independent directors to monitor or approve such conflicts?"[30]

**4. The Stromberg Report**

Mutual fund governance, as well as other issues in the Canadian mutual fund industry, appeared in the spotlight when the Stromberg Report was issued in January 1995. The Stromberg Report was more than 250 pages in length and it made recommendations with respect to various aspects of the Canadian mutual fund industry. The provisions of the Stromberg Report that relate to mutual fund governance are set out below.

"18.04 Investment Fund Governance

As noted above, investment funds are created by investment fund organizations on the basis that the investment fund organization will be responsible for providing or causing to be provided to the investment fund all of the services required by the investment fund to carry on its operations in the ordinary course. In many cases, the investment fund organization causes the investment fund to be created pursuant to a trust instrument that provides for it (or its affiliates) to be the trustee and manager. In other cases, the investment fund is established as a corporation, with the investment fund organization providing the requisite services pursuant to contractual arrangements.

In neither case are there requirements that "outside directors" or "unrelated persons" be involved - i.e. persons who are free of relationships and other interests which could, or could reasonably be perceived to, materially interfere with the exercise of judgment in the best interests of the investment fund.

As observed in Section 14, *I believe that there is something inherently wrong with a structure that permits all of the functions that are required to be carried out in respect of an investment fund to be carried out by related parties on terms that are in effect unilaterally imposed without there being some degree of review by* *unrelated persons who are considering the merits solely from the perspective of the best interests of the investment fund and its investors.*

*In the current structure, there is no one whose sole responsibility it is to look out for the interests of investors and it is not clear that the primary obligation of the investment fund manager is to put the interests of its sponsored investment funds ahead of all other interests.* As noted in Sections 2 and 3, investment fund organizations are focussed on gaining market share and benefitting their shareholders and other stakeholders. Their focus is not exclusively on their obligations to their sponsored investment funds.

*Most countries require that 'independence' be built into the structure and governance of investment funds either through the mechanism of requiring an independent trustee and custodian (i.e. a trustee and custodian that is not related in any way to the investment fund organization) which will be responsible for carrying out functions that cannot be delegated, or by having a specified percentage of outside directors of the investment fund.*

There were divergent views expressed about the merits of extending by analogy the statutory requirement for a board of directors that exists in the case of an investment fund that is a corporation to an investment fund that is a trust or other entity and to requiring that in either case there be a specified majority of 'outside directors' on such boards, with most people being opposed to the idea. The reasons given for this opposition include: (i) the multiplicity of investment funds within each group of sponsored investment funds, (ii) the increase in investment fund costs, (iii) the increase in time, paperwork and procedural workload required by investment fund managers to provide the board of the investment fund with information, (iv) proficiency issues respecting the persons selected to serve on the boards, and (v) the shortage of suitable people.

In questioning the need to require independent boards at the investment fund level, people referred to the fact that investment fund managers are currently under a specific statutory duty with respect to the investment funds they manage. They suggested that rather than adding another layer of supervision with the same supervisory duties it is preferable to increase the periodic management certification and audit procedure requirements to address specifically areas of potential conflicts and fair treatment of investors with respect to such matters as: (i) allocation of fund expenses, (ii) adequacy of fund valuation procedures, (iii) maintenance of capital levels, (iv) compliance with investment objectives, (v) adequacy of transfer agency services, and (vi) compliance with procedural requirements.

It was pointed out that investment fund managers that are public companies currently have boards of directors that have some ‘outside directors’ and are required to have audit committees, a majority of the members of which are outside directors. In some cases, these audit committees unofficially act as audit committees of the investment funds and in this context review expense allocations and the annual audited financial statements of the investment funds, meet with the external auditors of the investment funds and with internal accounting staff and review with the auditors the adequacy of all accounting controls as they impact the investment funds. It was observed that these boards and audit committees are aware of the statutory obligations of the investment fund manager and that they challenge management regularly as to the adequacy of procedures, controls, prospectus disclosure and other matters. It is suggested that rather than add a second board at the investment fund level, it would be better to prepare a list of matters that would have to be certified by management, the board of directors and the audit committee of the investment fund organization.

The suggestion was made that there should be a difference between the requirements for investment fund organizations that are public entities and investment fund organizations that are private entities with respect to any requirement that may be imposed to have ‘outside directors’. It has been pointed out that in the United States where there is a requirement to have ‘outside directors’, very few of the investment fund managers are public entities. Accordingly, it has been suggested by some that if investment funds are managed by an investment fund organization that is not a public entity there should be a requirement that such investment funds have a board comprised of a majority of outside directors.

It was suggested that if investment funds are to be required to have independent boards, there should only be a requirement for there to be a single board for all funds within the group(s) of funds sponsored by the investment fund organization. I am told that the reason for this suggestion that there be a single board relates to the difficulties that it is perceived that there would be in building the knowledge and awareness levels of the directors with respect to investment fund matters, preparing information for them and meeting with them and that it would be unduly onerous, in view of the number of investment funds, to have to do this with different boards for each investment fund managed by the investment fund organization or even with different boards for each group of investment funds managed by the investment fund organization.

It was pointed out that if independent boards of investment funds are to be required, there is a need to specify clearly the duties and responsibilities of any such boards and it has been suggested that these duties and responsibilities should be concentrated on conflicts, fairness and procedural issues. It was emphasized that the role of the independent board should not be to second-guess the investment decisions of the portfolio manager, or the decision to offer new funds, or to make changes in investment objectives of a fund, or to approve prospectuses, or to determine whether the manager has performed its statutory duty. It was suggested that the board should report its findings regularly to the manager and that it should provide a mechanism to correct any perceived shortcomings within a fixed period of time. If the board is not satisfied with the actions taken by the manager, the board should report to securityholders and to the appropriate securities regulatory authority so that further action could be taken.

With respect to the submission referred to above that enhanced review and reporting procedures for the board of directors of the investment fund manager, its audit committee and the external auditors of the investment fund manager would provide the same assurances that independent boards of investment funds would provide and at much less cost, I do not agree with the underlying thought reflected by this submission. In my opinion, enhanced requirements with respect to investment fund managers are desirable in their own right and should not be viewed as an alternative to an investment fund having an independent board.

Questions have been raised about whether, if investment funds have boards, this will require annual meetings for all investment funds to be held, the provision of management information circulars and proxy voting. It has been pointed out that the costs of these requirements will ultimately be borne by investment fund investors. Questions have been asked as to whether the fund manager or the board would be responsible for conducting the process, who would be willing to serve on the boards, how would the ‘outside directors’ be selected, what would the appropriate indemnification and insurance levels be and would the investment funds or the investment fund organization bear the cost of the directors/trustees' fees and insurance costs for the ‘outside directors’. These are legitimate administrative questions to raise but they do not go to the substantive issue of whether there is a need for independent boards.

*I think that the questions raised by those who do not consider that there is a need for an investment fund to have an independent board overstate the problems presented by the possibility of there being a requirement for an independent board and the costs that would be involved if this were to be required.* I am told that the information required to keep the members of an independent board of the investment fund informed is basically the same information that a manager requires. With respect to the question of whether there is a sufficient number of skilled people available to serve as independent members of the boards of investment funds, the basic need is for sound business persons who understand their responsibilities as directors. In my opinion, there is an obligation on the part of the investment fund manager to advise the outside directors on its own board and of the boards of its sponsored investment funds of what the issues are so that informed decisions can be made and actions taken. *The costs involved should more than be offset over the long run as it is reasonable to expect that the enhanced review and scrutiny of proposed transactions should result in more efficiently-run operations, lower fees being charged to investment funds and more controls exercised over the expenses that are charged to investment funds, particularly in cases involving transactions between the investment fund manager (or parties related to the investment fund manager) and its sponsored investment funds.*

Recommendations

Accordingly, in addition to the recommendations that I have made in Section 14 regarding the board of directors of an investment fund manager, its audit committee and the enhanced procedural and reporting requirements in respect of the operations of the investment fund manager, it is my recommendation that:

(1) *Investment funds should be required to have an independent board. The fact that tax laws have encouraged the use of structures other than corporations to constitute investment funds should not, in my opinion, eliminate the basic governance mechanisms reflected in a corporate structure.* The recommendations in Section 18.01 are intended to eliminate this difference.

I note that corporations that offer their securities to the public are required by law to have 'outside directors'. I do not see any reason why an investment fund the securities of which are offered to the public should be any different.

*While my recommendation that investment funds have independent boards goes beyond the current requirements of corporate law and the corporate governance guidelines recommended in the Dey Report that merely encourage the board of directors of a public company to be comprised of persons, a majority of whom are unrelated persons, I believe that there is justification for this by reason of the unique relationship that exists between the investment fund and its manager. This relationship gives rise to conflict of interest situations that occur on a continuing basis in the ordinary course of business and otherwise. In view of the fact that it is impractical for each situation involving a conflict of interest to be referred to securityholders for approval, it is essential that there be an independent body whose sole focus is the interests of the investment fund and its securityholders. It is also essential in the current environment affecting the investment fund industry where investment fund organizations are under considerable pressures to build critical mass and* *to secure access to distribution channels in order to survive, that there be such a body.*

(2) The applicable principles of good corporate governance (e.g. audit committees that are composed of at least a majority of unrelated directors) that are outlined in the Dey Report or will be articulated as a result of the follow-on work referred to below should guide the investment fund organization in establishing an independent board.

(3) To the extent that an investment fund organization deviates from the principles of good corporate governance that are outlined in the Dey Report or as a result of the follow-on work referred to below, it should include in the base disclosure document for the investment fund and in the annual report of the investment fund the reasons for any deviation from these guidelines.

(4) Further work should be done to identify the specific principles of good investment fund governance that should be applicable to investment funds so that there is uniformity of approach to this matter and investors are advised of what the standards are and are able to assess whether the protections offered by the respective investment fund organizations are sufficient. It may be that some legislative action is needed in this regard but this determination needs to await the articulation of what the appropriate principles of good investment fund governance should be.

As a minimum, there should be a requirement that mechanisms be in place to ensure that someone is reviewing all actions to ensure that they are in the best interests of the investment fund and its investors. This does not mean, nor should it result in, second-guessing the legitimate investment decisions of the portfolio manager. However, it does mean, for example, that there should be an audit committee with clear responsibilities in respect of the investment funds, including the review of expense allocations and the annual financial statements of investment funds.

I would expect that a result of the follow-on work would include guidelines aimed at: (i) clearly specifying the duties and responsibilities of an independent board that are focussed on conflicts, fairness and procedural issues, (ii) the development of effective procedures to address and remedy any unresolved shortcomings that may be identified by the independent board, and (iii) the development of appropriate provisions to address the administrative questions outlined above, many of which will be required to be dealt with in the development of the constating legislation referred to in Section 18.02 that I have recommended be passed. There is also a need to address the procedure for nominating

> persons to serve on the independent board and for filling vacancies that occur. In addition, there is a need to address the criteria for determining whether nominees are 'free of relationships and other interests that could or could reasonably be perceived to materially interfere with the exercise of judgment in the best interests of the investment fund'. In this respect, there is a need to address the issue of how many 'independent boards' an individual can be on before questions arise about whether the individual is 'free of relationships and other interests that could or could reasonably be perceived to materially interfere with the exercise of judgement in the best interests of the investment fund'."[31] [emphasis added]

**5. The Steering Group Report**

The Investment Funds Steering Group was formed following the publication of the Stromberg Report when the OSC, on behalf of the CSA, asked the Steering Group "to consider the recommendations contained in the Stromberg Report and to provide an industry perspective on them to the Canadian Securities Administrators (and other applicable regulatory agencies)".[32] The Steering Group members (consisting of Messrs. Jean Dumont, Arthur Labatt, Nicholas LePan, Bruce MacGowan, Arthur Mauro, John Palmer, Paul Starita and Edward Waitzer, with the assistance of Rebecca Cowdery as secretary to the Group) published its recommendations in the Steering Group Report in November 1996. The recommendations which are relevant to this report are as follows:

"• Registration of Fund Managers – the Canadian Securities Administrators should develop a system for the registration of, and continue to directly regulate, fund managers. …

• Fund Governance – The Canadian Securities Administrators should develop requirements for fund managers to create boards and audit committees to oversee the affairs of managed funds within fund families and articulate the duties and responsibilities for such boards.

- Conflicts of Interest – The Canadian Securities Administrators should recast the conflicts regime to take into account the existence and duties of fund boards and to recognize alternatives to strict prohibitions that may exist. …

- Internal Controls and Business Practices – The Canadian Securities Administrators should work with the industry to facilitate the development of good business practices, internal controls and infrastructure for both dealers and fund managers."[33]

Fund Governance

The Steering Group Report then elaborated on what it meant by the foregoing principles. I quote relevant sections from the Steering Group Report.

> "Fund Governance
>
> *We agree with the Stromberg Report recommendation that investment funds be required to have an independent board, board of governors or advisory committee with equivalent duties and responsibilities to those of the board of directors of a corporation.*
>
> Accordingly, each fund family should have a board of at least five members the majority of whom are independent of the manager and an audit committee comprised entirely of independent members of the board. …
>
> A fund board should not have the power to terminate the manager and appoint a new manager. The board's role is to monitor, review and approve (or ratify) certain actions of the manager as they relate to the fund in a particular fund family. If the board disagreed with or disapproved of a particular action of a fund manager, the board members would have the option of advising the securityholders of the relevant fund of the disagreement (which any of them should be able to do at the fund's expense) or resignation from the board or both. In practice, it is unlikely that a fund manager would act in a manner unacceptable to the fund board."[34] [emphasis added]

The Steering Group Report then listed various items which would fall under the responsibility of a fund board. The Steering Group Report went on as follows:

> "The powers, duties and responsibilities of the fund board should be set out in the constating documents of the fund (i.e. the declaration of trust for a trust fund and the articles of incorporation of a corporate fund). Any proposal to change these powers and responsibilities must be approved by the board and the securityholders.
>
> *Our reasons for endorsing the principle of an independent board at a fund family level are two-fold:*
>
> - *There should be a greater reliance of regulators on the 'watchdog' abilities and potential of a fund board than on strict regulatory prohibition and oversight. The primary obligation to protect the interests of securityholders should lie with the board, rather than with the regulators. Accordingly, an independent board should be granted the flexibility (coupled with the responsibility) to ensure that the fund is managed in a prudential fashion.*
>
> - *A fund board should serve to enhance the integrity of the industry, both in fact and in the perception of the investing public, which is essential to its continued success.*"[35] [emphasis added]

Conflicts of Interest

The Steering Group Report continued as follows:

> "It is important that the regulatory regime, in exercising powers of prohibition, recognize the fiduciary obligations of fund boards and managers and the ability of financial complexes to create effective barriers between related entities with competing interests.
>
> …We agree that an independent board should review transactions where potential for conflicts of interest exist, however, the regulatory regime should not

necessarily prohibit a transaction where adequate alternative mechanisms are in place that address and limit the conflicts of interest.

To the extent that existing regulations are maintained, regulators should consider alternatives to strict prohibition and limited (and difficult to obtain) exemptive relief. Examples of mechanisms and measures which could be used to address specific conflicts include disclosure, "chinese walls", review and approval by independent third parties (i.e. boards, audit committees, external auditors), restrictions and conditions."[36]

The Steering Group Report also noted in a footnote that the specific examples where alternatives to strict prohibition exist

"should be subject to oversight by the independent board and therefore each board must develop a policy and mechanism for review. Clarification is needed as to whether the board must 'pre-review' each transaction (this might be next to impossible in practice for the majority of transactions) or whether monitoring is sufficient with the ability for the fund board to require problematic transactions unwound."[37]

<u>A Code of Ethics for Fund Managers</u>

The Steering Group Report went on as follows:

"Fund managers, as a condition of their registration, should be required to adopt a code of ethics and business conduct and the board should be responsible for overseeing compliance with the code. Each fund manager's code should be on public file with the Canadian Securities Administrators, referred to in the fund disclosure documents and made available to investors upon request."[38]

<u>Business Practice Standards for Investment Fund Managers</u>

The Steering Group Report continued as follows:

"Proper internal controls, and the reasonable demonstration of proper controls, makes good business sense and is in the public interest. Proper internal controls for fund managers can be demonstrated in the following ways:

- Regulatory compliance reports, in addition to those presently required under National Policy Statement No. 39, to be filed, which could include reporting on activities commonly performed by fund managers such as valuation and investment management. …

- Auditors could be required to provide reports similar to those provided under Statement 89-7 of the American Institute of Certified Public Accountants for each fund. These reports should be addressed to the fund board and would be filed with the regulators.

Ultimately, internal control guidelines for fund managers and distributors should be developed and should take into account controls in existence at third party service providers as evidenced by Section 5900 reports. Any internal control framework should include minimum standards for business disaster recovery planning."[39]

<u>Regulation of Investment Fund Managers and Service Providers</u>

On this topic the Steering Group Report stated as follows:

"*Because of the manager's importance to an investment fund, managers of investment funds should be registered and thus directly regulated by the securities regulatory authorities*. The activities of a manager in managing a mutual fund should continue to be regulated as set out in National Policy Statement No. 39. Our recommendations in this area relate to giving securities regulators additional control and jurisdiction over the operations of mutual fund managers.

If managers are registered as such under securities legislation, there is no need to also require the registration of … other service providers. Funds themselves do not require 'registration'. Minimum standards should be imposed in respect of the provision of these services and perhaps the service providers themselves. These minimum standards should be included in either the conditions for registration of the manager or in a regulatory instrument (rule, regulation or direct legislation). By shifting the onus of monitoring the compliance of the service providers with applicable standards onto the manager, the manager retains

> ultimate responsibility to the investor for the quality and proper delivery of these services."[40] [emphasis added]

The Steering Group Report then commented on various specific items relating to the fund manager, of which I will refer to the following:

- Minimum regulatory capital;
- Insurance and bonding requirements;
- Internal controls;
- Senior manager proficiency requirements; and
- Monitoring service providers.

With respect to minimum regulatory capital, the Steering Group indicated that there is increased need for managers to invest more human and technological capital to manage and control the operations of mutual funds as they grow, and a minimum level of capital "provides some protection to investors as it helps to ensure that the investment funds can be compensated in the event of error, omission, fraud or theft"… .[41] The Steering Group indicated that the problem of insufficient capital tends to be found not in the managers of large mutual fund groups but rather "in the small, newly established investment fund managers with less than $100 million in assets under management who may not necessarily have sufficient operating revenue to finance operations".[42]

The Steering Group then recommended that the minimum capital requirements should require:

"(a) some level of working capital calculated in accordance with generally accepted accounting principles; and

(b) some level of net worth calculated under generally accepted accounting principles, based on net assets under management."[43]

The Steering Group suggested that regulatory capital should perhaps be a minimum of $1 million plus an additional amount that varies depending on the level of net assets under management.[44]

With respect to insurance and bonding requirements, the Steering Group recommended that managers maintain insurance for the following insurable risks (without recommending the actual minimum levels of such insurance): fidelity; "on premises"; "in transit"; forgery or alterations; securities; directors and officers; errors and omissions; property; and business interruption.[45] If the manager delegates responsibilities to third parties, the Steering Group recommended that the manager should ensure that the service provider is adequately insured.[46] The Steering Group also indicated that regulators should obtain "certification from the board of directors of the manager that full consideration has been given to the amount of bonding or insurance necessary to cover the insurable risks in the manager's business".[47]

With respect to internal controls, the Steering Group stated that "internal controls are especially important for the investment fund industry since managers are essentially dealing with 'other people's money' ".[48] In addition, the Steering Group went on to say that as "investment funds are not covered by CDIC [Canada Deposit Insurance

Corporation] insurance or CIPF [Canadian Investor Protection Fund]", then "investors must have a minimum level of protection".[49] I quote:

> "Specific minimum internal control procedures for transfer agency, trust accounting and fund accounting functions should be articulated. Where managers delegate these functions to third party service providers, managers should have the responsibility to ensure that the service providers follow the same minimum internal control procedures. …
>
> Once these controls are articulated, managers should be required to report annually on their compliance, and on the compliance of service providers with these controls. External auditors of fund managers could be required to report on these internal control compliance reports, with both reports filed with regulators."[50]

With respect to senior management proficiency requirements, the Steering Group recommended that to be registered, a manager must have the following senior management in place:

"• at least two persons performing the roles of a chief executive officer, a chief financial officer, a senior administrative officer and a senior compliance officer;

• officers that have a minimum of three to five years direct experience in the investment funds/securities industry or experience in serving the industry;

• senior officers that have successfully completed either the Partners', Directors' and Senior Officers' Qualifying Examination (offered by the Canadian Securities Institute) or the Officers', Partners' and Directors' Course (offered by IFIC) or acceptable equivalent;

• senior officers and directors that have passed the regulatory 'police check' and disciplinary check;

• at least a three person board of directors – this board need not be an 'independent' board as recommended by Commissioner Stromberg (on the

> assumption that an independent governance mechanism is adopted by the fund complex to act in the best interests of the family of funds)."[51]

With respect to monitoring of service providers, the Steering Group stated that a manager should have

> "procedures in place to carry out appropriate due diligence and monitor third party service providers with regard to their competence and compliance with specified internal controls, insurance and bonding and audit requirements. Managers should be held accountable for all delegated third party actions or omissions and should be responsible to ensure that managed mutual funds are indemnified for all losses occasioned by service providers actions or omissions, except investment decisions which comply with the investment objectives and restrictions. The use of service providers should not reduce the capital requirements for managers."[52]

In addition, service providers

> "should be required to have a S. 5900 audit (Opinions on Control Procedures at a Service Organization) performed by independent external auditors. These reports should be filed with the regulators as well as directed to the relevant managers."[53]

## 6. The Quebec Report

The Quebec Consultative Committee on the Regulation of Mutual Funds was given the responsibility of advising the Quebec Securities Commission and focusing on the features distinctive and concerns specific to Quebec within the scope of the national process of regulatory review of mutual funds commencing with the Stromberg Report. In January 1997 the Committee made the following recommendations in connection with mutual fund governance matters:

1. Mutual fund managers should be registered.[54]

2. Because a number of mutual fund managers in Quebec had assets under administration of significantly less than $100 million, the minimum level of regulatory capital should take into account the impact of capital requirements on such managers.[55]

3. There should not be compulsory registration of external providers of services but mutual fund managers should have ultimate responsibility for such service providers.[56]

4. There should be a mechanism to take into account the interests of the investor, which could be the form of a supervisory board for each family of funds the role and responsibilities of which would derive from corporate boards.[57]

5. There should be minority representation on the supervisory board of the fund family of individuals independent from the mutual fund manager.[58]

6. The existence of independent members on a supervisory board of a fund family should result in some reduction of direct regulation.[59]

7. The establishment of a supervisory board for each fund family should result in relaxation of certain rules on conflicts of interest.[60]

**7. The Second Stromberg Report**

The October 1998 Second Stromberg Report reiterated many of the comments in the 1995 Stromberg Report relating to fund governance. The following are a few short extracts from the Second Stromberg Report in this regard.

> "One of the most critical issues affecting consumer protection is fund governance. This subject has received little attention. Perhaps one reason is that the subject is abstract and intangible. There seems to be a certain lack of enthusiasm among a number of industry participants for focusing on fund governance. …
>
> The need to implement the recommendations [set out in the Stromberg Report] aimed at improving the governance provisions in respect of investment funds remains."[61]

**8. The Senate Committee Report**

The Standing Senate Committee on Banking, Trade and Commerce, chaired by The Honourable Michael K. Kirby, conducted a series of hearings on the role and governance practices of institutional investors beginning in November 1997. The resulting Senate Committee Report made the following recommendations in November 1998 in respect of the governance of mutual funds.

> "Recommendation
>
> *The Committee believes that independent directors have a key role to play in the governance of mutual funds. Their independent status leaves them free to focus on issues of fairness, conflicts of interest, and procedural and monitoring issues. Independent directors would not be there to second-guess the investment decisions of portfolio managers. Every mutual fund should be required to have a majority of independent directors. …*

Recommendation

The Committee recommends the enactment of legislation that would recognize a business trust structure that would be similar to a corporate structure and would include provisions for directors and officers of the trust and the extent of their independence, how they may be elected and removed, how fundamental changes in the trust would be made, and unitholders' rights and remedies.

Recommendation

Investors are entitled to know the risk management and governance practices of their mutual fund manager. They have a right to know what processes are in place to monitor the decisions taken on the risk exposures of the mutual fund, and if that monitoring is taking place.

When the Toronto Stock Exchange Committee on Corporate Governance in Canada (the Dey report) was released four years ago, the Toronto Stock Exchange (TSE) made it a requirement for all TSE listed companies to file public documents showing how they are complying with the guidelines for corporate governance put forward in the report. If a company chooses not to comply with the guidelines, it must state why.

With respect to the governance of mutual funds, if the fund manager is a publicly traded TSE company, it is subject to the Dey Guidelines. Other fund managers have no such formal responsibility.

The emphasis in the Dey Guidelines is on full disclosure. It is the view of the Committee that the same degree of disclosure should apply to all mutual funds in Canada. The Dey Guidelines should be adhered to by all mutual fund companies in Canada."[62] [emphasis added]

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1 *Report of the Canadian Committee on Mutual Funds And Investment Contracts – Provincial and Federal Study, 1969* (Ottawa: Queen's Printer, 1969) [hereinafter *1969 Mutual Funds Report*].

2 Consumer and Corporate Affairs, *Proposals for a Mutual Fund Law for Canada*, Vols. I & II by J.C. Baillie & W.M.H. Grover (Ottawa: Information Canada, 1974) [hereinafter *1974 Proposals*].

3 S.I. Erlichman, "Managing Potential Conflicts of Interest" in *Mutual Funds: New Products, New Competitors, New Rules* (Toronto: The Canadian Institute, 22 October 1993) [hereinafter *Conflicts Paper*].

4 *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Investment Funds in Canada*, Prepared by G. Stromberg for the Canadian Securities Administrators (Ontario Securities Commission, January 1995) [hereinafter *Stromberg Report*].

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[5] Investment Funds Steering Group, *The Stromberg Report: An Industry Perspective*, Prepared for the Canadian Securities Administrators (Toronto: Queen's Printer, November 1996) [hereinafter *Steering Group Report*].

[6] Consultative Committee on the Regulation of Mutual Funds, *La Modernisation du Cadre Normatif dans le Contexte Québécois*, Prepared for the Quebec Securities Commission (January 1997) [hereinafter *Quebec Report*].

[7] *Investment Funds in Canada and Consumer Protection: Strategies for the Millennium*, A Review by G. Stromberg prepared for Office of Consumer Affairs, Industry Canada (Ottawa: G. Stromberg, October 1998) [hereinafter *Second Stromberg Report*].

[8] *Report of the Standing Senate Committee on Banking, Trade and Commerce: The Governance Practices of Institutional Investors* (November 1998) (Chair: M. Kirby) [hereinafter *Senate Committee Report*].

[9] *1969 Mutual Funds Report*, *supra* note 1 at iv.

[10] *Ibid*. at 148-152.

[11] *Ibid*. at 158.

[12] *Ibid*.

[13] *Ibid*. at 158-159.

[14] *Ibid*. at 159.

[15] *Ibid*.

[16] *Ibid*. at 160.

[17] *Ibid*. at 160-166.

[18] *Ibid*. at 166-171.

[19] *Ibid*. at 173-176.

[20] *Ibid*. at 177-188.

[21] *Ibid*. at 188-191.

[22] *Ibid*. at 192-195.

[23] *1974 Proposals*, *supra* note 2 in Vol. I at 1.

[24] *Ibid*. at 3-4.

[25] *Ibid*. at 36.

[26] *Ibid*. at 16.

[27] *Ibid*. in Vol. II at 37.

[28] *Securities Act*, R.S.O. 1990, c. S. 5.

[29] *1974 Proposals*, *supra* note 2 in Vol. I at 54-55.

[30] *Conflicts Paper*, *supra* note 3 at 24-27.

[31] *Stromberg Report*, *supra* note 4 at 147-154.

[32] *Steering Group Report*, *supra* note 5 at 3.

[33] *Ibid*. at 5-6.

[34] *Ibid*. at 50-51.

[35] *Ibid*. at 52.

[36] *Ibid*. at 53.

[37] *Ibid*.

[38] *Ibid*. at 56.

[39] *Ibid*. at 63.

[40] *Ibid*. at 25-26.

[41] *Ibid*. at 26.

[42] *Ibid*.

[43] *Ibid*. at 27.

[44] *Ibid*.

[45] *Ibid*. at 28-29.

[46] *Ibid*. at 29.

[47] *Ibid*.

[48] *Ibid*.

[49] *Ibid*.

[50] *Ibid*.

[51] *Ibid*. at 30.

[52] *Ibid*.

[53] *Ibid*.

[54] *Quebec Report*, *supra* note 6 at 9 and 40.

[55] *Ibid*. at 10 and 40.

[56] *Ibid*. at 10 and 41.

[57] *Ibid*. at 10 and 42.

[58] *Ibid*.

[59] *Ibid*. at 10 and 42-43.

[60] *Ibid*. at 10 and 44.

[61] *Second Stromberg Report*, *supra* note 7 at 135-137.

[62] *Senate Committee Report*, *supra* note 8 at 3-4.

## IV. EXPLORING THE NEED FOR MUTUAL FUND GOVERNANCE

The 1969 Mutual Funds Report stated quite clearly why it is possible that transactions could occur in the mutual fund industry that are not in the best interests of mutual fund securityholders. In relevant part, the 1969 Mutual Funds Report stated as follows:

> "9.05 … In the mutual fund situation…it is less frequent for managers to look to the success of the mutual fund to generate their compensation. …The principal reward of the senior managers is derived from management fees or sales charges, and while these may be affected by the performance of the mutual fund the connection is less direct than is true with an industrial company manager who benefits directly from an increase in value of his company's shares. This might be expected to increase the susceptibility to conflicts of interest of the mutual fund manager. …
>
> 9.06 It should be emphasized that the considerations advanced…are not meant to imply that transactions designed to benefit management rather than the mutual fund are prevalent or even frequent in the Canadian industry, although…they do occur. In the United States, the *Investment Company Act of 1940* was preceded by a study that established abuses to be wide-spread, particularly among closed-end investment companies. …No allegations had been made that practices similar to those found to exist among investment companies in the United States during the 1930's were present on a wide-spread basis in the Canadian mutual fund industry; those of us who are securities administrators and other provincial securities administrators not members of the Committee, were aware of some transactions that might be criticized, but believed that the incidence of transactions designed to benefit management rather than the mutual fund was so low that it did not constitute a major problem of the industry. …Nothing we have ascertained during the course of this study has changed our opinion concerning the degree of incidence of self-serving transactions."[1]

I should preface this part of my report by stating what may be obvious but requires pointing out nonetheless. This report is prepared by a committee of one and this one is neither a private detective nor an economist. My mandate did not include ferreting out abuses (if any) which may exist on the management side of the Canadian mutual fund industry that a governance regime would most effectively and efficiently be able to rectify or assist in rectifying. Notwithstanding the foregoing, I would be remiss if I did not refer to several specific issues on the management side of the Canadian mutual fund industry that have been publicly reported. The CSA can determine if there are abuses on the management side of the Canadian mutual fund industry that have not yet been publicly disclosed. *I would point out, however, that I echo the views set out in the extract from the 1969 Mutual Funds Report quoted above: nothing in this report is "meant to imply that transactions designed to benefit management rather than the mutual fund are prevalent or even frequent in the Canadian industry, although … they do occur."*[2]

Let me now describe a few examples of issues arising on the management side of the Canadian mutual fund industry that have been publicly reported and which may have developed differently or perhaps would not have developed at all if an effective governance mechanism had been in existence.

1. The OSC decision in "In the Matter of David Singh, Jeffrey Lipton, Infinity Investment Counsel Ltd. and Fortune Financial Corporation"[3] received a great deal of publicity at the beginning of 1999. In simple terms, this case involved a mutual fund adviser which directed two of the mutual funds it advised to purchase securities of Infinity Income Trust which were offered for sale by a securities dealer that was affiliated with the adviser. The securities of Infinity Income Trust were being issued to raise money to finance deferred sales commissions payable

with respect to the sale of units of various mutual funds associated with the adviser. The Infinity Income Trust offering had a minimum closing threshold of $15 million and, if the two mutual funds had not purchased $1.5 million of Infinity Income Trust's securities in the offering, the minimum closing condition would not have been satisfied. The adviser would benefit from the closing of the offering as the proceeds would be used to pay down debt incurred to pay sales commissions which in turn would allow the adviser to secure additional credit facilities. In short order, the securities purchased by the mutual funds declined substantially in value. The purchase of the securities of Infinity Income Trust by the two mutual funds violated various conflict rules in the *Securities Act* (Ontario) and National Policy No. 39.[4] Under the terms of the settlement agreement with the OSC, the adviser was required (i) to reconstitute its board of directors so that it would be comprised of a majority of independent directors, and (ii) to devise and implement a conflict of interest policy acceptable to staff of the OSC.

What also is very interesting about this decision is that it is a publicly reported example of history repeating itself in the Canadian mutual fund industry. Let me excerpt a section from the 1969 Mutual Funds Report which describes a specific issue highlighted by the authors of that report:

"9.07 Our opinion that self-serving practices are not prevalent in the Canadian mutual fund industry has not led us to conclude that no controls are necessary in this area. The considerations outlined above establish at least the potentiality for acute conflicts of interest. We are aware of several specific situations which, although not representative of wide-spread practices, have caused us considerable concern. In at least two cases management has caused a mutual fund to invest in securities of other

> companies associated with management in transactions that we find difficult to accept as motivated by sound investment policy from the viewpoint of the mutual fund. In large numbers of cases mutual funds have purchased securities underwritten by associated brokerage firms, and while we cannot conclude in any specific instance that the purchase was not motivated by sound investment policy we regard such transactions as particularly susceptible of abuse."[5]

So, déjà vu.

2. There have been two recent cases decided by the OSC and widely reported in the press that dealt in part with possible "front running" by high profile individuals in the Canadian mutual fund industry, entitled "In the Matter of Frank Mersch and Peter Cunti"[6] and "In the Matter of Veronika Hirsch."[7] In both cases, the individuals were well-known, successful mutual fund portfolio managers who became aware of investment opportunities in which they decided to invest personally. Only at later dates did the mutual funds which they managed invest in the securities of the issuers in question. I emphasize that in neither case was front running proven and the OSC decisions were based on issues other than front running (i.e., the settlement agreements with the OSC indicated, in the case of Mr. Mersch, that he admitted to deliberately misleading the OSC investigators who looked into the transactions and, in the case of Ms Hirsch, that she acknowledged that she provided false information on a document in order to qualify for a private placement by the issuer).

As an aside, trading by portfolio managers for their own account was recently described in the Wall Street Journal as a major issue in the U.S. mutual fund industry. The article stated in relevant part as follows:

> "Regulators have fretted for years about conflicts of interests that can arise when mutual-fund managers trade for their own personal account. It turns out that the regulators aren't alone in their concern.
>
> Personal trading and insider trading by fund managers are two of the most pressing concerns among asset-management company executives, according to a new survey by PricewaterhouseCoopers conducted earlier this year. The survey, released this week, showed that 74% of respondents found personal trading by managers a 'high concern'. Meanwhile, more than 80% put insider trading, either by managers for their personal portfolio or the mutual funds they run, in that category.
>
> 'These are integrity issues,' says Barry Barbash, a former Securities and Exchange Commission mutual-fund regulator… . They address the trustworthiness 'of the people in charge' of mutual funds."[8]

3. The allocation of trades among clients of an adviser has received public attention in both Canada and the United States. The issue raised is the method of allocation of securities between the private counsel clients and the mutual fund clients of an adviser and then, with respect to the securities allocated to the mutual fund clients, the method of allocation of the securities among the various mutual funds overseen by the adviser. In this regard, the staffs of the United States Securities and Exchange Commission ("SEC") and the OSC released a joint letter in August 1998[9] which summarized some of the violations of the United States *Investment Advisers Act of 1940* and the *Securities Act* (Ontario) and the Regulation thereunder and related instruments that were found during securities compliance

examinations of investments advisers registered jointly with the SEC and OSC. One of the items in this letter relates to trade allocations and states as follows:

> "Described below are examples of ways that advisers may breach their fiduciary obligations to clients by allocating trades inequitably among clients.
>
> - Advisers breach their fiduciary obligation to clients by favoring certain accounts over others in allocating hot initial public offerings…without disclosing this practice to clients and obtaining their consent to the practice. By practicing such favoritism, advisers prejudice their other clients by depriving them of valuable and suitable investment opportunities. …
> - Advisers breach their fiduciary obligation to clients by waiting to decide how a trade should be allocated based on subsequent market movements. The result is that favored clients are allocated the trade if the price movement was favorable and other accounts are allocated the trade if the price movement was unfavorable. This practice is known as 'cherry-picking'… .
> - Advisers breach their fiduciary obligation to clients by failing to use the average price paid in allocating securities to accounts participating in a bunched trade. Securities purchased at the lowest price or sold at the highest price are allocated to favored clients. …"[10]

4. Certain conflicts are inherent in the structure of Canadian mutual fund complexes that are affiliated with financial institutions and such conflicts may create a public perception (often resulting from newspaper articles and other media reports) that the conflicts lead to abuses. For example, unproven allegations of potential conflicts with respect to two mutual fund organizations affiliated with different Canadian chartered banks (relating in one case to a mutual fund manager requisitioning a shareholders' meeting of a company in the mutual fund's portfolio for a purpose which, if approved at the meeting, could be beneficial to

the bank, and in the other case to fees paid to a bank and its affiliated investment dealer by a company in the mutual fund's portfolio) were recently reported in newspaper articles.[11] Even if these allegations are totally without merit, however, I suggest that in an industry where having the trust and confidence of the public is essential it is critical to reduce to a minimum level any adverse public perception.

I would also point out that the mutual fund structure in Canada, by its very nature, is rife with actual and potential conflicts. For example, mutual funds are organized and operated by persons who are employed by entities other than the mutual fund itself. Accordingly, these people have pecuniary interests in the manager or other entities apart from the mutual fund. As a result, there are inherent potential conflicts of interest in the mutual fund structure between the interests of the securityholders of the mutual fund, on the one hand, and the interests of the manager of the mutual fund and other persons rendering services to the mutual fund, on the other hand. Add to this the fact that in a typical Canadian mutual fund structure, the trustee, manager and investment adviser and, in some cases, the registrar and transfer agent, may be the same entities or may be entities within the same corporate group, thereby also raising potential conflicts. Some conflicts are addressed by existing conflicts rules while others are not. The fact that conflicts are inherent in the mutual fund structure, however, may create a public perception that the conflicts lead to abuses. I reiterate that in an industry where having the trust and confidence of the public is essential, one must endeavour to reduce to a minimum level any adverse public perception.

It may not be surprising that few problems on the manager side of the Canadian mutual fund business have been publicly reported to date. I understand that the OSC, for example, began compliance reviews of registered advisers only in September 1997 and there has been no specific focus on advisers to mutual funds as opposed to any other registered advisers. In this regard, I quote from a paper presented by Paul Bourque, Director, Market Operations of the OSC, on September 16, 1998 entitled "The OSC Program for Adviser Compliance":

> "In 1994 compliance at the OSC was one accountant reviewing financial statements submitted by registrants directly to the OSC – the "desk review". In the same year two accountants were hired specifically to do field examinations and a few were conducted that year. In January 1996 the compliance team was formed at the OSC. …
>
> Today the compliance team has a total of 10 staff, a manager, 2 administrative assistants and 7 compliance examiners. We plan to add 7 additional compliance examiners and those plans are currently under review to assess whether more examiners can be effectively employed. …"[12]

Accordingly, empirical evidence of possible problems is just beginning to be developed.[13]

There seem to be very few individuals who have publicly opposed the creation of a governance regime in the Canadian mutual fund industry. One person who has been willing to go on the record is Lawrence Schwartz, a Canadian economist who has written various articles and newspaper columns stating that there is no need to import U.S. style boards of directors into Canadian mutual funds. In his submission to the Standing Senate

Committee on Banking, Trade and Commerce on May 28, 1998 entitled "The Canadian Approach to Mutual Fund Governance", Mr. Schwartz concluded as follows:

> "It would be nice if there were any evidence [of abuses on the manager side of the Canadian mutual fund industry] on the record. The Ontario Securities Commission recently surveyed fund dealers and found and publicized a number of shortcomings. However, there has been no similar inquiry into funds or management companies. There is only undocumented anecdote and suspicion.
>
> It may be that the appropriate investigation would find shortcomings and might conclude that the current fund governance system is flawed. That the current governance regime might be flawed in these respects, however, would not in itself justify a significant change. The American alternative is also flawed, and perhaps more so than the status quo.
>
> The governance question is not whether to replace an imperfect system with a perfect one. Rather, as with many issues of public policy, we must choose between imperfect alternatives. In this respect, we may have to settle for something that works well and is better than the next best alternative, even if it is not perfect."[14]

The clear implication from Mr. Schwartz's submission and his other writings is that the present Canadian system is working well and there is no evidence to show that if Canada adopted the U.S. system which has as its underpinning a board of directors for each mutual fund, that Canadian investors would be any better off.

The November 1998 Senate Committee Report responded to Mr. Schwartz's submission as follows:

> "Not everybody agreed with the need for more attention to the governance of mutual funds. Mr. Lawrence Schwartz presented arguments against implementing a corporate-style governance regime for mutual funds in Canada. He maintained that there are no compelling reasons for adopting such a regime

> and contended that proposed reforms are driven by suspicion about non-standard, unincorporated investment vehicles. Mr. Schwartz argued that there has been 'no demonstration of unit holder abuse in Canada and certainly none that independent boards uniquely could have prevented'. He felt that the Canadian regime, which combines regulation and fee structures, provides adequate incentive for fund managers to act in the interests of unitholders.
>
> Mr. Schwartz was of the view that the adoption of governance structures similar to those currently operating in the United States could lead to more litigation and additional regulation. He also foresaw problems with implementing change and felt that to be effective governance reform measures would have to be accepted nationally; something that he felt would be difficult to achieve.
>
> The Committee did not find the views of Mr. Schwartz persuasive. The Committee believes that there is a need for the implementation of a corporate-style governance regime for mutual funds in Canada. The recommendations that follow reflect this view of the Committee."[15]

I suggest that there have now been a few publicized incidents (and possibly other non-publicized occurrences to which Ms Stromberg and others have referred in the past and that are still "undocumented anecdote and suspicion"[16] (to use Mr. Schwartz's phrase)) which might not have occurred in the first place or, if they occurred, might have been resolved in a simpler manner, if an effective fund governance regime had been in existence.

With the Canadian mutual fund industry reported to have more assets under administration than savings deposits in the Canadian banking system,[17] abuses could place investors' savings at risk. Accordingly, I suggest that we must try to reduce the potential for abuses arising. I also suggest that, although Canadians are not as litigious as our neighbours to the south, trying to prevent problems ahead of time through a governance regime is a more efficient way to handle issues rather than resorting to litigation to resolve problems that might have been alleviated had an effective governance regime been in existence in the first place.

I also believe that there are certain realities of the Canadian mutual fund marketplace that would make it unfair to force investors to rely on the market mechanism of "voting with one's feet" in lieu of an effective governance regime. In Canada the majority of mutual fund securities are sold on a back-end load basis. In addition, mutual funds investors, more than investors in individual public corporations, are passive investors who are told by the fund industry to take a long term perspective on their mutual fund investments. Accordingly, I suggest that an investor should not be forced to exit because the cost of "voting with one's feet" is contrary to the emphasis that the mutual fund industry places on investing for the long term and also because a forced exit may have associated costs, such as payment of redemption fees or, in the case of mutual fund securities held outside of registered plans, realization of a capital gain or loss which may be undesirable.

What is appropriate for Canada, however, is not necessarily the full panoply of U.S. style regulation. I make this comment because it is interesting to see that there are reported problems today in the U.S. mutual fund industry that are very similar to possible issues in the Canadian mutual fund industry, notwithstanding that the U.S. mutual fund industry has had as its underpinning for almost 60 years a requirement of boards of directors for investment companies. The Investment Company Institute ("ICI") discussed some of these current U.S. problems in the June 1999 Report of the Advisory Group on

Best Practices for Fund Directors entitled "Enhancing a Culture of Independence and Effectiveness" (the "ICI Best Practices Report"), which stated in part as follows:

> "While the Act contains broad prohibitions against various types of self-dealing transactions, funds can be faced with other, perhaps more subtle, conflicts. These potential conflicts may involve such diverse matters as the allocation of brokerage commissions, the use of fund assets for distribution, the allocation of expenses between a fund and its adviser and among funds, responsibility for any pricing errors or violations of investment restrictions, and personal investing by officers and employees of the fund's adviser. In these and many other areas, independent oversight of fund operations by fund directors helps to ensure that funds will be operated in the best interests of shareholders."[18]

I also would add that even though verifiable empirical proof that an effective governance regime is in the best interests of mutual fund securityholders may never be obtained, common sense indicates that instituting some sort of regime in Canada is in the best interests of securityholders. In this regard, Ira M. Millstein, a well-known commentator on and participant in corporate governance issues in the U.S., published an article about corporate boards of directors entitled "Red Herring Over Independent Boards" in The New York Times in April 1997, which I think is quite apt. The following is an excerpt from Mr. Millstein's article:

> "Good corporate governance is based on the seemingly noncontroversial premise that an independent attentive board, structured to monitor management's performance, is more likely to detect and address problems and provide real accountability to shareholders. …
>
> …In 'The Origin of the Species,' Darwin noted, 'A grain in the balance will determine which individual shall live and which shall die.'

> I suggest that an independent, attentive board is the grain in the balance that leads to a corporate advantage. …
>
> …Shareholders rely on professional managers to carry on the business, and this distinct specialization of investment and management has proved uniquely successful. Nonetheless, human nature being what it is, the shareholders' agents, the managers, may tend to forward their own interests, with the danger that they will make decisions, or become entrenched or enrich themselves, at the expense of the shareholders. An independent attentive board serves as a monitor to the shareholders to lessen the impact of this agency problem.
>
> I don't think we really need to try to prove mathematically that such a board is needed. In a recent article, Mr. Solow [a Nobel laureate in economics] aptly identifies the problem in the search for econometric 'proof' of which I complain. 'In economics, model builders' busywork is to refine their ideas to ask questions to which the available data cannot give the answers,' he wrote, likening this to having 'the overeducated in pursuit of the unknowable.' 'There is a tendency to undervalue keen observation and shrewd generalization,' he added, noting that 'there is a lot to be said in favor of staring at the piece of reality you are studying and asking, just what is going on here?'
>
> …[W]hy not bow to Darwin's logic and accept the grain that may well tip the balance in favor of survival: the board that is performing well? I see no need to await definitive proof. It probably will never come, and it isn't necessary."[19]

I concur with this common sense approach to the issue of whether a governance regime adds value to a business organization. A governance regime for mutual funds, if properly structured and implemented, may do more than just assist in detecting and rectifying problems. The governance regime, as an adjunct to competition in the marketplace among mutual fund organizations, may result in better performance by the fund manager which in turn may lead to better performance by the fund adviser, possibly resulting in increased returns to the fund securitytholders. Depending upon the type of governance regime that is established, the existence of a governance regime also might lead to the loosening of the conflict rules relating to mutual funds, with the securities regulatory authorities relying on the governance mechanism to monitor transactions that otherwise would be prohibited or would require exemptions from existing securities laws. Let me briefly discuss these two issues.

**1. Does Better Governance Lead to Better Performance**

There is some empirical evidence in the corporate area, and to a lesser extent in the pension fund and mutual fund areas, which suggests that better governance leads to better performance for investors.

In the corporate area there have been various studies trying to link better corporate governance with better performance for shareholders. The international consulting firm McKinsey & Company tried to ascertain the worth of good governance by conducting a survey of U.S. institutional investors "to compare two well-performing companies (such as those with consistent profits and number one or two in terms of market share) and state whether they [i.e., institutional investors] would pay more for the stock of one of these companies if it were well governed."[20] For purposes of the survey, well-governed companies were defined as having, at a minimum: (i) a clear majority of outsiders on the board; (ii) truly independent directors with no management ties; (iii) directors who hold significant stock holdings and who are paid, to a large extent, in stock; (iv) directors who are formally evaluated; and (v) boards that are responsive to investor requests. According to the McKinsey paper, two-thirds of the institutional investors said they would pay more for the stock of a well-governed company, with the average premium for such governance being eleven percent.[21] The McKinsey study stated that there are three main reasons why investors will pay a premium for good governance of U.S. companies:

> "Some believe that a company with good governance will perform better over time, leading to a higher stock price. This group is primarily trying to capture upside, long-term potential.
>
> Others see good governance as a means of reducing risk, as they believe it decreases the likelihood of bad things happening to a company. Also, when bad things do happen, they expect well-governed companies to rebound more quickly.
>
> Still others regard the recent increase in attention to governance as a fad. However, they tag along because so many investors do value governance. As this group sees it, the stock of a well-governed company may be worth more simply because governance is such a hot topic these days."[22]

The McKinsey paper concluded as follows:

> "The survey findings should be viewed in the light of two caveats. First, such a survey can only be a rough attempt at quantifying the value of board governance. Second, the findings do not suggest that governance should be the top priority for CEOs. A number of items rank higher, including strategy, cash flow, competitive position, quality of the management team, and cost control. *Nonetheless, the survey indicates clearly that governance deserves a position somewhere on the priority list. Moreover, the findings of our survey and interviews are supported and supplemented by a growing number of independent academic studies.*
>
> *Believing in the value of corporate governance should no longer be a question of faith. Some investors will pay a significant premium for good governance*. And though it is more important in some circumstances than in others, and more important to managers of some types of funds than others, it remains clear that good board governance can serve as a tool for attracting certain types of investors, as well as influencing what they will pay for stock."[23] [emphasis added]

In November 1999 McKinsey followed up its earlier study by asking investors in Asia, the United States and Europe to rate five Asian countries' corporate governance and whether they were willing to pay a premium for well-governed companies in these Asian countries. In a presentation which at last check has yet to be publicly reported, McKinsey stated as follows in response to the question of how important the quality of governance is relative to financial issues in evaluating Asian companies for potential investments:

> "Over three-quarters of respondents believe the quality of governance is at least as important, if not more, than financial issues."[24]

The McKinsey presentation continued by stating that investors are willing to pay a "[s]ubstantial premium for well governed companies"[25] and also that "[w]ith U.S. as base case, Asian companies can improve their value through corporate governance enhancement."[26]

I understand that McKinsey is continuing its studies in this area by carrying on such surveys in connection with European and Latin American companies.

In a June 1998 article in The Columbia Law Review, Ira Millstein and Paul MacAvoy wrote an essay entitled "The Active Board of Directors and Performance of the Large Publicly Traded Corporation".[27] The introduction to the essay stated in part as follows:

"Observation and reasonable assumptions lead the authors to the working hypothesis that a professional board – a board that is active and independent of management – should be associated with higher returns to investors. The authors test their hypothesis through an economic analysis of potential returns to investors defined as 'economic profit' – operating earnings in excess of the costs of capital – and the authors' judgment as to the presence or absence of a professional board in a sample of 154 large publicly traded domestic corporations. *The data analysis from 1991-1995 demonstrates that there have been significant increases in 'economic profit' where a professional board was present. Although the results do not prove causation, corporations with active and independent boards appear to have performed much better in the 1990s than those with passive, non-independent boards*."[28] [emphasis added]

The conclusion to the essay was as follows:

"In the 1990s, boards of directors have become active and more independent, aligning themselves more closely with shareholder interests. We believe they have induced or caused management to increase residual earnings, ultimately for the benefit of shareholders. However, there has been intense debate as to the extent to which active and independent boards have had such an effect on corporate performance. Attempts to validate empirically a relationship between independent boards and superior corporate performance have produced mixed results. We believe these results have followed from concentrating on data from earlier periods, and on single indicators of board structure which cannot validate such a relationship. Only active behavior of the board generates organizational behavior that improves earnings. A test for 'active governance' is required, and our test – based on our observation, experience, and logical assumptions – indicates that such behavior generates improved corporate performance.

There is little doubt that an active board aligned with shareholder interests would attempt to enhance value to shareholders. Because it is unrealistic to think that singular changes in board structure alone, without accompanying new activist behavior, would affect corporate performance, we have identified holistic surrogates for boards active in incentivizing and monitoring management performance. Using responses to a CalPERS survey, we have identified those corporations in which the surrogates for professional board behavior have been present, based on our perception of these surrogates. We analyzed a large sample of corporations with two metrics: first, the grade assigned by CalPERS for governance, and second, a 'presence' or 'absence' grade we assigned based on our evaluation of key surrogates for professional board behavior.

> Both metrics have demonstrated a statistically significant relationship between an active, independent board and superior corporate performance as measured by earnings in excess of costs of capital over the industry average. Corporations that received an 'A +' CalPERS corporate governance grade and corporations that we graded as having active governance 'present' both performed significantly better in generating earnings in the 1990s than did the other corporations in the sample of large domestic corporations.
>
> *This research demonstrates a substantial and statistically significant correlation between an active, independent board and superior corporate performance*. We believe that the superior performance is a result of activist corporate governance. However, we recognize that such a demonstrated correlation between governance and performance does not prove causation. Causation may be impossible to establish, and we leave future study of causation to those who are concerned with it, remarking only that proof of causation is absent in every piece of research we have seen so far on this subject.
>
> *Even without proof of causation, the substantial and significant relationship between activist board governance and corporate economic performance cannot be dismissed*. It might be inferred that managers willing to assume the risks associated with a professional board are better able to generate higher returns to shareholders. On the other hand, why do so? It seems to us less than likely that good corporate governance is a luxury of firms that are performing extraordinarily well.
>
> Further study could determine the effects of such factors as market concentration, barriers to entry, and demand volatility on the level of excess earnings. Even so, we expect that such studies will confirm our findings of significantly enhanced earnings of corporations with activist boards. We believe the corporate governance revolution has had demonstrable positive effects on earnings generated by operations of the large domestic corporations."[29] [emphasis added]

I also point out that in the corporate context, the Dey Report stated, without referring to empirical evidence, as follows:

> "We recognize that the principal objective of the direction and management of a business is to enhance shareholder value, which includes balancing gain with risk in order to ensure the financial viability of the business. A system of corporate governance is only as good as its contribution to the attainment of these

> objectives. We believe that effective corporate governance will, in the long-term, improve corporate performance and benefit shareholders."[30]

Turning to the investment management area, an article by Keith Ambachtsheer, Ronald Capelle and Tom Scheibelhut entitled "Improving Pension Fund Performance" was published in the November/December 1998 Financial Analysts Journal.[31] The article reported on a study which addresses both the measurement of and determinants of pension fund performance, with the primary goal of the study being to "explore the relationship between how pension funds perform and how they are organized".[32] The study described in the article involved 80 U.S. and Canadian pension funds with an aggregate asset value of US$668 billion. The authors of the study developed a questionnaire for senior pension fund executives to score 45 statements about their organization. The statements were organized into three sections reflecting "the three basic dimensions of organization design-governance (16 statements), planning and management (12 statements), and operations (17 statements)".[33] Let me quote a few excerpts from the article:

> "In short, organization design quality as identified by the CEO scores appears to be a powerful additional factor in fund performance. …
>
> Although the power of these findings is limited by the smallness of the samples, they contain an important message: Pension fund CEOs apparently have a good enough feel for the quality of their organization design that their relative perceptions correlate positively with relative organization performance. When these perceptions are replaced by more scientifically based, objective measures of organization design quality, the correlation between design and performance is even stronger. *This evidence is persuasive that the direction of causality is from good organization design to good organization performance, not the other way around. …*

> Recall that the 80 CEO scores that rated organization design quality were based on the average of how each CEO scored 45 statements about organization design. When we correlated each of the 45 individual statement scores separately with the organization's performance, only 11 of the 45 statements passed the statistical significance test. Thus, these 11 statements … warrant a closer look. …
>
> Note also … that six of the statements are governance related, four are planning and management related, and only one is operations related. …
>
> *Good governance mattered most, with good management a close second*."[34] [emphasis added]

The article also stated that 8 pension fund organizations came together in a December 1997 symposium to discuss how the findings of the study might be used to improve organization performance. The conclusions they reached with respect to governance are as follows:

> "*Strategies to improve the performance of the board of governing fiduciaries have a high payoff*. One strategy is to provide governing fiduciaries with high-quality education. Another is to have the board evaluate its own effectiveness, which will help the board focus on 'doing the right things' rather than simply 'doing things right.' (Right things include deciding the fund's mission, selecting the pension fund CEO, clearly delegating management authority, and monitoring outcomes against plans.)"[35] [emphasis added]

The article concluded as follows:

> "The governance and management of the world's pension assets must be in strong hands. Only pension fund organizations with clear missions, effective governance, and good organization design can make global pension fund capitalism work."[36]

The Association of Canadian Pension Management ("ACPM") published a report in January 2000 entitled "Dependence or Self-Reliance: Which Way for Canada's Retirement Income System?"[37] The primary goal of this paper was stated as "raising awareness of the challenges which lie ahead, and laying out what actions we could take to make our retirement income system both fairer and more sustainable as it enters an extended period of demographic turbulence."[38] The paper stated that:

> "Canadians have already accumulated a collective retirement savings nest egg approaching $1 trillion. …Clearly, it is critical that we manage these assets wisely. An important strategy to ensure this is the adoption of 'best practice' fiduciary governance processes which foster effective fund management in both the pension and investment fund sectors."[39]

Let me quote certain excerpts from the report relating to both pension fund governance and investment fund governance:

> "Because net investment returns have such a major impact on the adequacy and cost of future retirement income streams, how well or poorly investment funds are managed matters a great deal. Recent research confirms that the two most critical ingredients in the management of pension funds are fund size, and the quality of their governance and management processes. On average, larger pension funds with highly rated governance/management processes have had significantly better investment results (eg., 1% per annum higher risk adjusted net returns or better) than smaller funds with poorly rated processes. Using the rule of thumb developed above, this means large, well governed and managed pension funds will deliver 20% higher pensions for a given contribution rate than small, weakly governed and managed pension funds.
>
> In explaining these findings, the research noted that larger pension funds can take advantage of significant economies of scale to reduce unit operating costs. Also, they have the ability to hire a qualified pension fund executive to whom the fund's governing fiduciaries can delegate the creation and implementation of a strategic plan for the pension fund. These steps lead to clarity about the organization's mission and vision. They also lead to clarity about organization

> design, the delegation of responsibilities, and about how results are to be measured. Smaller funds, on the other hand, tended to have significantly higher unit operating costs, and tended to have incomplete, part time governance and management structures. As a result, many of the organizational characteristics associated with good governance and management tend to be missing. This in turn produced, on average, relatively poor investment results.
>
> In economic terms, we are dealing with a phenomenon called 'informational asymmetry'. Specifically, the providers of financial services such as portfolio management are specialists with a great deal of knowledge about financial markets and how they work. In contrast, pension plan members and sponsors generally only have limited knowledge. This 'asymmetry' gives the services providers a material potential advantage in contracting with the buyers of their services. It is only when the buyers are represented by a sophisticated pension fund organization that the informational playing field is leveled, or even tipped in favor of the pension plan stakeholders. Only in these latter cases can stakeholders reasonably expect to receive full 'value for dollars'. …
>
> We believe that the findings of the pension fund research study cited above are directly relevant in an investment fund context. Indeed, for obvious reasons, the 'informational asymmetry' problem we cited above is even more prevalent and severe at the retail level. As a result, for example, where most pension funds incur annual operating costs (expressed as % of assets) in the 0.1% to 0.5% range, many investment fund investors pay annual fees in excess of 2%. Canadian investment fund investors currently do not benefit from boards of governing fiduciaries legally charged with looking after their financial interests."[40]

Accordingly, I suggest that although much work still has to be done to develop more empirical evidence as to the relationship between better governance and better performance, in the absence of such evidence we should rely on common sense and make "empirical assumptions" with respect to the relationship between fund governance and fund performance.

### 2. Interaction of a Governance Regime and the Mutual Fund Conflict Rules

Canadian securities laws provide a complex set of rules which prohibit various transactions within a mutual fund complex unless exemptive relief is obtained from the CSA. The conflicts rules are described in detail in a staff paper of the OSC entitled "Regulating Conflicts of Interest in the Management of Mutual Funds: The Current Regime".[41] Other conflicts are referred to in my 1993 Conflicts Paper previously quoted in Part III of this report under the heading "History of the Mutual Fund Governance Debate in Canada",[42] in a 1994 paper prepared by the International Organization of Securities Commissions ("IOSCO")[43] referred to under the heading "3. IOSCO – Conflicts of Interest" in Part VI of this report, in my 1996 paper entitled "Fiduciary Duties and Conflicts of Interest in the Canadian Mutual Fund Industry",[44] in my 1997 paper entitled "Fiduciary Duties and Conflicts of Interest in the Canadian Mutual Fund Industry: An Update"[45] and in a May 2000 report of the Technical Committee of IOSCO entitled "Conflicts of Interests of CIS Operators".[46]

The CSA Investment Funds Implementation Group (previously referred to in Part II of this report) ranked conflicts of interest as a medium priority, dependent on the results of a fund governance project. The Implementation Group proposed that the CSA should review the Stromberg Report recommendations "with a view to determining whether any alternatives to strict prohibition exist or whether any changes to the conflicts regime applicable to mutual funds should be made".[47] The Implementation Group noted that the conflicts of interest project is "contingent on the development of [an] independent fund governance mechanism and therefore cannot be completed before fund governance is worked out".[48]

Depending upon the type of mutual fund governance regime that is established in Canada, the existence of a governance regime might lead to the loosening of the conflicts rules relating to mutual funds, with the CSA relying on the governance mechanism to monitor transactions that otherwise would be prohibited or would require exemptions from existing securities laws. The interaction of conflicts of interest and the U.S. mutual fund governance regime is described in the following extract from a December 1999 speech by the Director of the SEC's Division of Investment Management:

> "You probably would agree that the unique role played by a fund's independent directors has enabled the Commission to provide flexibility to the industry as it confronts the restrictions imposed by the 1940 Act. Historically, the Commission's exemptive rules and orders, particularly those permitting transactions between a fund and its affiliates, have relied to a significant degree on the oversight provided by the fund's board, and especially its independent directors.
>
> This will become increasingly the case in the new millennium. As the financial services industry undergoes consolidation on a global scale, the Commission will be called upon both to provide the flexibility needed to accommodate change, as well as to ensure investor protection. The Commission will have to rely in no small part on the funds' independent directors. This underscores the importance of the Commission's fund governance initiative."[49]

In Part VII of this report under the heading "1. Recommendations Regarding Establishing an Independent Governing Body" I indicate that in theory the CSA could consider providing certain types of relief from existing regulatory constraints only to fund organizations that adopt a specific form of governance regime. Such an opt in procedure would create an incentive for various mutual fund organizations to adopt a specific type of governance regime and will therefore cause the mutual fund organizations to weigh the potential benefits of the proposed relief against any potential detriments relating to the adoption of this specific form of governance regime. An opt in procedure of this nature is discussed in a recent release by the SEC relating to the role of independent directors of investment companies, to which I also refer later in Part VII of this report.

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1 *Report of the Canadian Committee on Mutual Funds and Investment Contracts – Provincial and Federal Study, 1969* (Ottawa: Queen's Printer, 1969) at 274-275 [hereinafter *1969 Mutual Funds Report*].

2 *Ibid*. at 274.

3 *Singh (Re)* (1999), 22 O.S.C.B. 462.

4 Although not stated by the OSC, the purchase of the securities of Infinity Income Trust by the two mutual funds also may have violated fiduciary duties of the trustee or manager of the two mutual funds. In this regard, a recent text on unit trusts states as follows: "Thus, a manager cannot direct the trustee to use the trust fund to buy assets from itself or through its associate companies. Similarly, where the manager is an associate of an underwriter of a share issue, the manager may not direct the trustee to subscribe for the new shares when the sign of under-subscription occurs. Nor may it direct the trustee to buy from the underwriter when the subscription is unsuccessful if the purpose is to 'dump' unwanted securities to the unit trust.". (See Kam Fah Sin, *The Legal Nature of the Unit Trust* (Oxford: Oxford University Press, 1997), at 196-197).

5 *1969 Mutual Funds Report, supra* note 1 at 275.

6 *Mersch (Re)* (1998), 21 O.S.C.B. 3805. Mr. Mersch's employer, mutual fund manager Altamira Management Limited, had entered into a settlement agreement with the OSC in 1997 relating to other allegations, namely improper high closing trades on the Toronto Stock Exchange, improper internal cross trades between related funds and the level of market dominance in trading of shares of Dorset Exporation Ltd. See *Altamira Management Ltd. (Re)* (1997), 20 O.S.C.B. 4721.

7 *Hirsch (Re)* (1997), 20 O.S.C.B. 5708.

8 See Aaron Lucchetti, "Personal Trading Troubles Fund Officials", *Wall Street Journal* (15 June 1999) at C27.

9 L.A. Richards and P.C. Bourque, "Compliance by Advisers Registered with the OSC and the SEC" (1998), 21 O.S.C.B. 5587.

10 *Ibid.* at 5587.

11 J. Patridge & J. McNish, "Royal Assailed for Funds' Role in Onex Bid" *The Globe and Mail* (9 September 1999) B10; E. Reguly, "Royal's Integrity Intact in Airline Issue" *The Globe and Mail* (11 September 1999) B2; "Vox: All in the family" *The Globe and Mail* (5 January 2000) B10.

12 P. Bourque, "The OSC Program for Adviser Compliance" in *Mandatory Compliance for Investment Counsel and Portfolio Management* (Toronto: Strategy Institute, 16 September 1998).

13 Under the Hong Kong Code on Unit Trusts and Mutual Funds, if securities of a mutual fund are to be sold in Hong Kong the investment management operations of the fund management company or those of the investment adviser (where the latter has been delegated the investment management function) must be based in a jurisdiction with an inspection regime acceptable to the Hong Kong Securities and Futures Commission. A list of acceptable regimes is set out in an Appendix to the Code and, interestingly, Canada is not one of the jurisdictions listed (although, for example, both the United States and the United Kingdom are listed). The Code indicates that the list is not exhaustive and does not imply that other jurisdictions are necessarily unacceptable. Perhaps Canada is not on the list because of the fairly recent commencement of inspections of investment management firms here.

14 L. Schwartz, Ph.D., “The Canadian Approach to Mutual Fund Governance” (Paper presented to the Senate of Canada Standing Committee on Banking, Trade and Commerce, 28 May 1998).

15 *Report of the Standing Senate Committee on Banking, Trade and Commerce: The Governance Practices of Institutional Investors* (November 1998) (Chair: M. Kirby) at 37-38 [hereinafter *Senate Committee Report*].

16 Schwartz, *supra* note 14 at 15.

17 John A. Geller, Q.C., the Vice-Chair of the Ontario Securities Commission, recently stated that “Canadians now have more money invested in mutual funds than on deposit with banks and trust companies” (See “In the Best Interests of Investors: Strengthening Fund Governance” (Keynote Address to The Canadian Institute’s Eighth Annual Mutual Funds Symposium, Toronto: The Canadian Institute, 18 October 1999) which can be found at (1999) 22 O.S.C.B. 6557). The Investment Funds Institute of Canada (“IFIC”) reported assets under management by its members of $413.5 billion as at March 31, 2000 and IFIC has advised that, as at that date, almost 100% of mutual fund managers in Canada were members of IFIC (Statistics can be found on the IFIC website at www.ific.ca/eng/frames.asp?I1=statistics). This figure may be compared to savings deposits in the Canadian banking system as at March 31, 2000, which totaled $338.6 billion (Bank of Canada Banking and Financial Statistics).

18 *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (Investment Company Institute, 24 June 1999) (Chair: J. Brennan) at 8-9.

19 I.M. Millstein, “Red Herring over Independent Boards” *The New York Times* (6 April 1997) Money & Business 10.

20 R.F. Felton, A. Hudnut & J. Van Heeckeren, “Putting a Value on Board Governance” (1996) 4 McKinsey Quarterly 170.

21 *Ibid.* at 171: “Among those willing to pay more for good governance, the average premium specified was 16 percent. However, a minority of those investors who said they would pay more felt the actual premium was hard to quantify. Based on the entire survey group, including those who said they would not pay more, the average premium was 11 percent.”

22 *Ibid.* at 173.

23 *Ibid.* at 175.

24 McKinsey & Company, “Value of Good Board Governance” (Presentation to the Asia-Pacific Institute, Hong Kong, 5 November 1999)[unpublished].

25 *Ibid.* at 5.

26 *Ibid.* at 6.

27 I.M. Millstein & P.W. MacAvoy, “The Active Board of Directors and Performance of the Large Publicly Traded Corporation” (1998) 98 Colum. L. Rev. 1283.

28 *Ibid.* at 1283.

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[29] *Ibid*. at 1317-1318.

[30] *Report of The Toronto Stock Exchange Committee on Corporate Governance in Canada: "Where Were the Directors"*: *Guidelines for Improved Corporate Governance in Canada* (December 1994) (Chair: P. Dey, Q.C.) at 2.

[31] K. Ambachtsheer, R. Capelle & T. Scheibelhut, "Improving Pension Fund Performance" (November/ December 1994) Financial Analysts Journal 15.

[32] *Ibid*. at 15.

[33] *Ibid*. at 16.

[34] *Ibid*. at 17-18.

[35] *Ibid*. at 19.

[36] *Ibid*. at 20.

[37] The Association of Canadian Pension Management, *Dependence or Self-Reliance: Which Way for Canada's Retirement Income System?* (January 2000). This document can be found on the ACPM website at www.acpm.com/ACPMenglish/documents/dep_selfreliance.htm.

[38] *Ibid*. at 1.

[39] *Ibid*.

[40] *Ibid*. at 23-25.

[41] Ontario Securities Commission, "Regulating Conflicts of Interest in the Management of Mutual Funds: The Current Regime" (1995) 18 O.S.C.B. 1168.

[42] S.I. Erlichman, "Managing Potential Conflicts of Interest" in *Mutual Funds: New Products, New Competitors, New Rules* (Toronto: The Canadian Institute, 22 October 1993).

[43] Report of the Technical Committee of the International Organization of Securities Commissions (IOSCO), *Report on Investment Management – Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum* (October 1994). This document is available in full on the IOSCO website (www.iosco.org).

[44] S.I. Erlichman, "Fiduciary Duties and Conflicts of Interest in the Canadian Mutual Fund Industry" in *Fiduciary Obligations: Implications for Financial Institutions and Funds* (Presentation to the Osgoode Hall Law School of York University Professional Development Programme, 2 October 1996).

[45] S.I. Erlichman, "Fiduciary Duties and Conflicts of Interest in the Canadian Mutual Fund Industry: An Update" (Presentation at the Insight Conference on "Developing Business Practice Codes in the Investment and Fund Industries", 26 March 1997).

[46] Report of the Technical Committee of IOSCO, *Conflicts of Interest of CIS Operators (May 2000)*. This document is available in full on the IOSCO website.

[47] "Report of the CSA Investment Funds Implementation Group Endorsed by the Canadian Securities Administrators" (1997) 20 O.S.C.B 2512 at 2518.

[48] *Ibid*.

[49] P.F. Roye, "Mutual Funds – A Century of Success; Challenges and Opportunities for the Future" (Remarks before the Securities Law Developments Conference ICI Education Foundation, 9 December 1999) available at the U.S. Securities and Exchange Commission website: http://www.sec.gov/news/speeches/spch336.htm.

## V. SURVEY OF MUTUAL FUND GOVERNANCE STRUCTURES

In this part of the report, I will highlight key characteristics of the mutual fund governance regimes in the United States, the United Kingdom, Australia, Hong Kong and Japan as well as the existing regime in Canada.[1] The mutual fund governance structures of these countries illustrate that there are a variety of approaches to the issue of how to try to ensure that decisions made in a mutual fund complex are made in the best interests of the securityholders. The information contained in this section of my report relies heavily on two sources to which I am indebted.[2]

### 1. Organization of the Mutual Fund

#### (a) Legal Structures

Throughout the world, the legal structures of mutual funds tend to take one of two basic forms: either a corporate form or a contractual form (including a trust form, which is a variant of the contractual model). The most significant difference between these two types of structures is that in the corporate form the mutual fund is a separate legal entity organized as a corporation while in the contractual form the mutual fund is a relationship (in the case of a trust, a relationship among the trustee and the beneficiaries) and is not a separate legal entity unless applicable legislation makes it one. For example, in subsection 1(1) of the *Securities Act* (Ontario) the definition of "person" includes a trust and therefore under Ontario securities law a mutual fund trust is treated as a separate legal entity. The corporate model is used in the United States (where a U.S. mutual fund can be either a corporation or a trust, but by virtue of the *Investment Company Act of*

*1940* (hereinafter the "1940 Act" or the "*Investment Company Act of 1940*") and business trust legislation in some of the states, the trust is treated as if it were a corporation), while Canada, Hong Kong and the United Kingdom permit the use of both the corporate and the contractual form (in which mutual funds take the form of trusts). In Australia, investment schemes, which are sometimes described as "managed funds", are structured primarily as public unit trusts, although there are also trustee company common funds and cash management trusts. In Japan, the existing mutual fund legislation was recently amended to allow corporate investment funds in Japan in addition to the use of a trust structure.

**(b) Legislative and Regulatory Requirements**

Within the parameters of the two structures, countries have created differing legislative requirements for mutual fund governance. In fact, it is arguable that the choice of a trust rather than a corporate entity (or vice versa) is not determinative with respect to the protections afforded to the securityholders and that the level of protection afforded to investors is determined instead by the legislative requirements of a jurisdiction.[3] For example, in Canada both the trust and corporate model are available as structures for mutual funds, with the trust being the more prevalent model. In practice, apart from the provisions of the applicable corporate statutes (to which I refer in Part VII under the heading "7. Recommendations Regarding Securityholder Protection"), there is no substantial difference between the investor protection afforded to securityholders under the two different legal structures.

In the United States, each mutual fund has a board of directors, elected by the mutual fund's securityholders. Where a vacancy on the board arises between securityholder meetings, a vacancy can be filled without a securityholder vote only if immediately after filling the vacancy at least two-thirds of the directors then holding office were elected by the securityholders.[4] Securityholder meetings are generally held annually. The mutual fund has an investment adviser that provides services to the fund pursuant to the terms of a contract and has a custodian that holds the assets of the fund.

In the United Kingdom, there are two available structures for mutual funds, unit trusts and open-ended investment companies ("OEICs"). Unit trusts are unincorporated bodies constituted by a trust deed made between the manager and an independent trustee. An OEIC is a corporate entity that must have an authorized corporate director ("ACD") which is responsible for the management of the mutual fund. Depositories act as the custodians of the assets of the OEICs and trustees perform the same function for unit trusts. OEICs in the United Kingdom qualify as undertakings for collective investment in transferable securities (i.e., "UCITS") under the 1985 UCITS Directive of the European Union and, accordingly, can be marketed across the European Union.[5] As a result, the governance model applicable to OEICs is accepted across the European Union.

In Hong Kong, there are two types of structures available for mutual funds, corporations and trusts. Each requires an investment manager that is responsible for the mutual fund's compliance with applicable laws. The corporation will have an independent custodian, and the trust will have an independent trustee, each of which has some responsibility for monitoring the investment manager's conduct and holds the assets of the fund.

In Australia, mutual funds are typically structured as trusts. Each trust must have a responsible entity (a "Responsible Entity") which is a public company[6] that acts as the operator of the fund and is responsible for the internal controls relating to the operation of the fund. The Responsible Entity has a board of directors. An external custodian holds the property of the fund, unless the Responsible Entity can demonstrate that it is able to hold such property in accordance with certain requirements (including the segregation of assets and certain capital requirements). Each Australian mutual fund must have a written constitution that complies with the legislation and a compliance plan that deals with the matters prescribed by the legislation.

In Japan, mutual funds are structured as either securities investment trusts or securities investment corporations. In the case of mutual funds established within Japan (as opposed to foreign funds), the following parties must be involved (in addition to the investors): an investment trust management company, a trust bank and a distributor. Each of the parties needs certain approvals to be obtained from the Japanese government. For example, a license must be obtained for conducting a discretionary investment management business (a "DIM"). In addition, an investment adviser must be registered under *The Investment Advisors Law* of Japan.[7]

As I noted above, Japan recently amended its Securities Investment Trust Law to, among other things, allow corporate-type investment funds in Japan. According to a recent article,[8] corporate funds were introduced in Japan to promote the interests of securityholders of the fund through enhanced corporate governance. The author notes, however, that Japanese investors do not seem to be interested in or familiar with theories of corporate governance, and concludes that this type of fund may not become popular in Japan in the near future.

## 2. Oversight Responsibility

Each governance regime must in some manner allocate responsibility for overseeing the management of the mutual fund in order to try to ensure that the interests of securityholders guide the management of the fund. The regimes differ with respect to the extent to which reliance is placed on persons within the mutual fund complex to administer a system of internal controls, as opposed to the allocation of this oversight responsibility to outside regulators (either in government or in a self-regulatory organization). For example, in some jurisdictions regulatory approvals are required for the appointment of certain key parties to the mutual fund complex and the regulator plays a role in sanctioning certain core components of the arrangements between the parties, whereas in other countries these matters are left either to the discretion of an independent board or to the discretion of the manager.

In the United States, the oversight responsibility for the mutual fund is placed squarely on the shoulders of the fund directors, who are involved in most aspects of the fund. In contrast, in Japan the oversight responsibility for mutual funds rests mainly with the Financial Supervisory Agency (the "FSA") which was established in 1998 and is the

Japanese authority in charge of the supervision of mutual funds. In countries such as Australia, Canada, Hong Kong and the United Kingdom, the oversight roles of persons in the mutual fund complex (i.e. the trustees, depositories and directors, as applicable) are more limited than in the United States, but more active than in Japan.

For example, in Australia the Responsible Entity oversees the operation of the mutual fund, but the legislation also provides for significant powers to reside in the Australian Securities and Investment Commission ("ASIC"). Every mutual fund must be registered with the ASIC and each Responsible Entity must hold a dealer's license, which license to be granted (or refused) by the ASIC on the basis of such factors as the educational requirements of the responsible officers of the applicant and minimum capital requirements. The legislation provides that the Responsible Entity must report to the ASIC any breach of the law that relates to the scheme where the breach of law is likely to have a material adverse effect on the interests of securityholders. In addition, the Responsible Entity must notify the ASIC if a breach of the terms or conditions of its license has occurred. The ASIC also has the power to check, from time to time, whether the Responsible Entity is complying with the fund's constitution and the relevant legislation.

In Canada, the system in existence today consists of a manager of the mutual fund which has the day to day responsibility for the fund, whether that fund is structured as a trust or a corporation. In a mutual fund corporation, the board of directors of the fund oversees its operation, whereas in a mutual fund trust the trustee (which often is, or is an affiliate of, the manager) has responsibilities under contract, common law and possibly statute to the securityholders.[9] The provincial securities administrators also are responsible for overseeing the mutual fund. A mutual fund must be approved by the securities regulators prior to receiving permission to be sold to the public. Its initial approval entails a comprehensive analysis by the regulators. In order to be approved, the mutual fund must submit a simplified prospectus and an annual information form and material contracts, including constating documents, as well as other statutory documents. After a review and comment period, the fund will make revisions and, if the changes are approved, the regulators will issue a receipt for the prospectus. The securities regulators use the prospectus renewal process to ensure that those mutual funds selected for review are fulfilling their obligations. Mutual funds file financial statements with the applicable securities administrators. In some instances, regulators may compare the investment objectives of a mutual fund with the fund's financial statements to see if the investments made by the fund during the past financial periods conform to the investment objectives. Regulators also may use the mutual fund's financial statements and statement of portfolio investments to verify that the fund has complied with the statutory investment limits. In addition, in a role similar to that played by many regulators in other jurisdictions, the provincial securities administrators also regulate both mutual fund trusts and corporations with respect to the licensing of investment advisers and mutual fund dealers both initially and on an annual basis thereafter.

### 3. Conflicts of Interest

Because the interests of fund management and the interests of fund securityholders are not always aligned, regulators have set up mechanisms to try to constrain a fund manager from putting its own interests or the interests of its affiliates ahead of those of the fund securityholders. This goal has been accomplished through several differing types of legislative requirements. First, legislation can disallow certain specified types of related party transactions. Second, legislation can mandate that there be an independent review of the actions of management in order to provide a check on behalf of securityholders. Third, legislation may provide that certain parties are subject to fiduciary duties of honesty, care and loyalty in exercising powers and carrying out duties in favour of securityholders. Governance regimes of different jurisdictions use some or all of these techniques in an attempt to minimize the potential for conflicts of interest between those managing the fund and those investing in it.

In Japan, matters such as self-dealing and conflicts of interest are regulated. The legislation itself disallows DIMs from self-dealing by prohibiting specified transactions, including transactions with affiliated parties on a non-arm's length basis and acquiring securities which were underwritten by affiliated parties and left unsold. Prior to the recent changes in legislation, the Japanese Minister of Finance had to approve the contents of each trust deed and any changes made to it. Now, under the *Law Concerning Securities Investment Trusts and Securities Investment Corporations,* the creation of and amendments to the trust arrangement may be made without approval, but are subject to a prior notification to the Commissioner of the FSA. [10]

In Japan, no independent party scrutinizes the fairness of the remuneration of the management committee or the expenses charged to the trust. However, one of the requirements for obtaining a license for conducting a DIM in Japan is that the DIM must have a certain degree of independence from related companies (i.e. those companies which have a stake in the DIM). One aspect of this "independence" is that the number of "non-permanent directors" of the DIM who are at the same time engaged in the daily business of the main related company to the DIM must not exceed 50% of the total number of directors of the DIM. In addition, the main related company must not grant economic assistance (such as a salary supplement or rental fee assistance) to the DIM, nor can the business office of the DIM be located inside a business dedicated solely for the head office of the main related company.[11]

In contrast, in the United States there is a requirement that a minimum number of independent directors serve on the board of the investment company (at least 40% and up to 75% where a change of control has occurred) who are expected to act as a check on the actions of the parties in the mutual fund complex. Directors are considered to be independent if they do not fall into the definition of "interested persons"[12] under the 1940 Act. The board of directors of the mutual fund is responsible for supervising certain aspects of the management of the fund and in certain situations it is mandated that the majority of the independent directors approve particular actions, including the approval of the contract of the investment adviser. In addition to the requirement of independent directors, the 1940 Act prohibits certain related party transactions between the investment company and its affiliates. These restrictions generally require SEC approval for affiliates to buy from or sell to a fund as principal, to borrow from a fund or to engage in joint transactions in which a fund participates. Under state law, both the adviser and the members of the board of directors are fiduciaries with respect to the fund. In addition, directors are subject to action by the SEC for breaches of duty involving personal misconduct.[13]

In the United Kingdom's unit trust model, the manager of the trust and the trustee are required to be independent of each other. In the corporate OEIC model, it is the depository (which performs the equivalent role to that of a trustee of a unit trust) that must be independent of the ACD (which performs a similar function to that of the manager of a unit trust). Regulations of the Securities and Investment Board prohibit dealings with affiliates of the parties to the unit trust or OEIC, unless those dealings are at least as favourable to the unit trust or OEIC as would any comparable arrangement effected on normal commercial terms between two independent parties. Managers of unit trusts and the ACD of an OEIC have obligations derived from the general law, the instrument of incorporation (in the case of an OEIC), the prospectus, the Financial Services Regulations and the rules of the self-regulatory organizations. In addition, both the management company and the trustee of the unit trust are considered fiduciaries. Trustees and depositories are required to act solely in the interests of securityholders.[14]

In Australia, if the Responsible Entity does not have a majority of external directors, a compliance committee (comprised of a majority of external individuals) of the mutual fund must be established to monitor the required compliance plan. Thus, the Australian system demands some type of independent review of compliance of the mutual funds, whether that review takes place in the form of a majority of external directors of the Responsible Entity or by way of a compliance committee of the mutual fund. The Responsible Entity also is subject to a duty of honesty in addition to a statutory duty of care and diligence and is required to act in the best interests of members. The Australian legislation specifically provides that in the event that there is a conflict between the interests of the mutual fund's securityholders and those of the Responsible Entity, the Responsible Entity must give priority to the interests of the securityholders of the mutual fund. There also are provisions in the Australian legislation which regulate related party transactions. A Responsible Entity is prohibited from conferring a financial benefit to itself or to a related party out of the property of the fund or that could diminish or endanger the scheme property, unless the legislation specifically permits the benefit to be given. Among the statutory exceptions to the prohibition is where such benefit is provided on arm's length terms.

In Hong Kong, there is a requirement that the trustee/custodian (as applicable) and the management company be independent of one another. Any transactions between the mutual fund and the management company may be made only with the prior consent of the trustee/custodian (as applicable), and in addition to satisfying other conditions, must be carried out on arm's length terms.

Some jurisdictions have adopted codes of conduct to regulate the behaviour of managers of funds. In Australia, the ASIC has the statutory power to approve industry codes of conduct, but they have not yet been approved. However, as noted above, as an internal matter a mutual fund must have a compliance plan which sets out the framework for the operation of the scheme by the Responsible Entity.[15] In Hong Kong there is a "Fund Manager Code of Conduct" as well as a "Code on Unit Trust and Mutual Funds" which governs requirements and obligations of mutual funds. Other jurisdictions regulate conduct through legislation. In addition, many funds have their own internal codes of conduct.

In Canada, there is a statutory standard of care for management of a mutual fund, an example of which is set out in subsection 116(1) of the *Securities Act* (Ontario), and common law fiduciary obligations. If we carry on with our current regime, we implicitly will be following the "if it ain't broke, don't fix it" theory, as set out in my 1993 Conflicts paper:

> "Accordingly, if one subscribes to the 'if it ain't broke, don't fix it' theory, one could advocate continuing to rely upon the existing rules and existing remedies for breach of the rules. Under this scenario one would continue to rely on the fiduciary obligations of the trustees, managers, investment advisers, on the restrictions set out in the *Securities Act* (Ontario) and other securities legislation across the country and in National Policy No. 39, on the disclosure required in prospectuses and annual information forms by National Policy No. 36, National Policy No. 39 and securities legislation and on the remedies available upon abuse, namely the power of the regulatory authorities such as the Ontario Securities Commission to investigate alleged problems and to issue orders (such as cease trading orders), to levy fines or not to issue receipts for prospectuses thereby not permitting renewals of fund prospectuses, and the power of securityholders to commence litigation if they cannot otherwise obtain an adequate remedy."[16]

What I would add to the foregoing quote is the fact that the existing Canadian regime also has provincial regulations that prohibit certain specified transactions with affiliated or related parties of the fund manager. In addition, we now have class action proceedings in Ontario and several other provinces in Canada and contingency fees are permitted in those class actions, bringing us somewhat closer to the U.S. litigation model. The advent of class actions is another arrow in the quiver to be considered in the context of existing Canadian mutual fund governance.[17]

## 4. Investors' Rights

Investors in open-ended mutual funds have the opportunity to liquidate their investments in order to express their disapproval of fund management's decisions regarding any aspect of the fund. As I mentioned earlier, the right to "vote with one's feet" does not necessarily provide a great deal of investor protection, as there often are barriers to exiting a mutual fund, including taxation and other exit fees. Certain jurisdictions, however, provide investors with substantial powers in addition to the right to walk away from their investment.

In Canada, for example, securityholders are entitled to vote on certain fundamental changes to their mutual funds, including a change in the basis of the calculation of fees or expenses which could result in an increase in the management expense ratio, a change in manager and a change in the fundamental investment objective of the mutual fund. If the mutual fund is structured as a corporation, securityholders holding voting shares also are entitled to vote at annual meetings to, among other things, elect directors and appoint an auditor.

In Australia, investors in mutual funds have the right to do the following, among other things: remove and replace the Responsible Entity; veto changes to the constitution of the fund (except where those changes will not, in the reasonable opinion of the Responsible Entity, adversely affect the rights of the securityholders); veto certain financial benefits to the Responsible Entity; and direct the Responsible Entity to wind up the fund. Investors in Japanese securities investment trusts, on the other hand, have none of these rights accorded to Australian mutual fund investors.

In the United States, in addition to the right to elect directors of the investment company in certain circumstances (as noted above, vacancies on the board of directors between securityholder meetings may be filled without securityholder approval if immediately after filling any such vacancy at least two-thirds of the directors then holding office have been elected to such office by the securityholders), a majority of securityholders must approve any fundamental change in the mutual fund's investment policies and securityholders must approve any material changes in the contract with the investment adviser or in any distribution plan. In the United Kingdom, approval of 75% of the votes at a securityholders meeting also is required for any proposed significant change to the investment policy of a fund (whether it is a trust or an OEIC). In both the United Kingdom and in Hong Kong, securityholders are entitled to remove management through a vote, with a 75% majority required in the United Kingdom and a 50% majority required in Hong Kong.

## 5. An Innovative Model

I already noted in the introduction to this chapter that the level of investor protection provided by a particular governance regime is not necessarily tied to its legal structure but rather that the level of such protection is more closely tied to the substance of the legislation of the jurisdiction. Even within a given jurisdiction's regulatory structure, however, there can be opportunity for innovation. The structure adopted by the Vanguard Group in the United States is an example of such innovation.

The Vanguard Group is one of the largest mutual fund organizations in the United States (over U.S. $539 billion in assets in some 100 investment portfolios as of December 31, 1999) with a unique corporate structure.[18] According to Vanguard's internet website, the manager of the Vanguard Group is the only U.S. mutual fund organization to be owned by its member funds (the "Vanguard Funds"). Contrary to the traditional fund structure in which the external management company is typically owned by a small group if the manager is a private company or by investors who purchase the management company's publicly-traded shares if the manager is a public company, the Vanguard Funds are separate mutual funds that together own the manager of the Vanguard Group. Thus, the securityholders of the Vanguard Funds indirectly own the mutual fund manager through their ownership of securities of the Vanguard Funds. This structure is perhaps the purest model of aligning the interests of the mutual fund securityholders with the interests of the mutual fund manager.

The following extracts are taken from the Vanguard Group's publication entitled "The Vanguard Advantage 1999":[19]

> "*Our Structure and Mission*
>
> …A key factor in our success is our unique corporate structure. Vanguard is the only *mutual* mutual fund complex – we are owned by the funds themselves and exist only to serve their shareholders. The typical mutual fund is a 'captive', controlled by the external management company that charges fees for overseeing the fund and seeks to earn substantial profits for its efforts. By contrast, the

Vanguard funds are independent investment companies that jointly own The Vanguard Group, the management company that provides services to the funds on an at-cost basis. This structure dictates that the profits we generate be returned to fund shareholders in the form of lower operating expenses.

*Vanguard Values*

…Ever mindful of the trust placed in us by our clients, we put our fiduciary duty to them first and foremost, ahead of marketing or other considerations. This 'client-first' philosophy allows us to focus on getting better, not bigger. …

*A Focused Company*

Serving these clients is the reason for our unique corporate structure, which is designed to eliminate the conflict that exists in other fund complexes between clients and management firms. …"

The Chairman of The Vanguard Group stated as follows in The Vanguard Advantage 1999:

"*Chairman's Message – Vanguard's Value Added*

Vanguard's mission statement declares that we strive to provide the highest-quality services 'at the lowest reasonable cost.' This is no mere slogan. I can report that our operating costs continue to be the lowest for any mutual fund family. …According to the latest data available from Lipper, our fund-operating costs averaged 0.28% of average net assets ($2.80 per $1000 in assets) during 1998, compared with the industry average expense ratio of 1.25% ($12.50 per $1000 in assets). This huge expense advantage is due in part to our unique 'at cost' operating structure. Our low costs are the most consistent contributor to our solid long-term performance record. And while costs are by no means the only factor one should consider when making an investment, they do matter – and matter a great deal – because a mutual fund's operating and transaction costs diminish the return that shareholders earn.

If Vanguard had charged the industry average expense ratio of 1.25% during 1998, our shareholders would have paid about $3.7 billion more in fund-operating

> costs (the 0.97% difference in expense ratios multiplied by our average assets of $377 billion). …"

There is one small mutual fund group in Canada, Tradex Management Inc. ("Tradex"), which has attempted to create a mutual fund structure similar to the Vanguard Group model. According to Tradex, since 1960 the board of directors of the manager of Tradex Equity Fund Limited has had a majority of independent directors. Currently, nine of ten directors of the manager are independent. As well, each of the four Tradex funds managed also has been overseen by a fund committee since 1991. Each fund committee is made up of two independent directors and two other fund investors. The mandate of the manager is to operate "at cost", with any excess revenue to be shared annually by the funds, proportionate to assets. At the present time, according to Tradex, the management expense ratio of the Tradex funds is among the lowest in Canada, but the manager has yet to experience excess revenue to pass onto the funds.

## 6. Conclusion

As the foregoing outline of various structures shows, and as the recently published IOSCO survey of governance structures in various countries also illustrates,[20] there are various models of governance utilized by mutual funds in the world today. As the next chapter points out, some of these jurisdictions recently have enacted legislation to reform their governance regimes while others are considering reforms now. There is no consensus that one form of governance regime is overwhelmingly better than other models.

[1] The information contained in this chapter is largely based on secondary sources and has not been verified by legal counsel in such jurisdictions.

[2] P.S. Stevens, "Mutual Fund Governance Structures – A Comparative Analysis", (Investment Company Institute, 11th Annual International Investment Funds Conference, October 1997) [hereinafter *Mutual Fund Governance Structures*] and *IOSCO Working Party No. 5 on Investment Management, Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators* (February 2000).

[3] *Mutual Fund Governance Structures*, *supra* note 2 at 2.

[4] Section 16(a) of the U.S. *Investment Company Act of 1940* [hereinafter *1940 Act*].

[5] According to Francois Delooz, Head of the Asset Management Department, Commission des Operations de Bourse, France, less than 10% of mutual funds in Europe comply with the 1985 UCITS Directive of the European Union and thus only these few qualifying funds have the benefit of the "European passport" which permit securities of the funds to be offered throughout the European Union (oral comments of Mr. Delooz at the "Meet the Regulators" session on May 1, 2000 of the IBA 11th Annual Conference "Globalization of Mutual Funds", Bermuda, 30 April – 3 May 2000).

[6] The definition of "public company" in Australia is not the same as the definition under Canadian law. For example, an Australian public company does not have to be listed on a stock exchange nor does it have to be widely held. It does, however, mean that the company is subject to particular disclosure requirements under Australian law.

[7] Y. Kimura, "Japanese Investment Fund Regulations Updated" (IBA 10th Annual Conference "Globalization of Mutual Funds", Bermuda, 2-5 May 1999) at 22.

[8] *Ibid.* at 17.

[9] For example, the trustee will have obligations arising from the trust agreement as well as from common law fiduciary principles. In addition, section 116 of the *Securities Act* (Ontario) provides that "every person or company responsible for the management of a mutual fund shall exercise the powers and discharge their duties of its office honestly, in good faith and in the best interests of the mutual fund, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances". An unanswered question is whether section 116 is meant to regulate the trustee of a mutual fund in those cases where it is not the manager of the mutual fund.

[10] Kimura, s*upra* note 7 at 12.

[11] *Ibid.* at 28.

[12] The *1940 Act* designates certain categories of persons to be interested in section 2(a)(19), including affiliates of the company and any interested person of any investment adviser of or principal underwriter for such company. Even if a person does not fall within one of the specific categories of interested persons, the SEC has the residual authority to issue an order that such a person is interested if it finds the person has a "material business or professional relationship with certain specified persons and entities".

[13] Section 35 of the *1940 Act*.

[14] According to Phillip Thorpe, the Managing Director and Head of Authorization, Enforcement and Consumer Relations, Financial Services Authority, England, there are only eight or nine entities in England which act as independent trustees of unit trusts or independent depositories of OEICs (oral comments of Mr. Thorpe at the "Meet the Regulators" session on May 1, 2000 of the IBA 11th Annual Conference "Globalization of Mutual Funds", Bermuda, 30 April – 3 May 2000).

[15] Attached as Schedule A to Part VII of this report is an Australian Securities and Investments Commission policy statement relating to mutual fund compliance plans.

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16 National Policy 39 and National Policy 36 have been reformulated as National Instruments 81-101 and 81-102 respectively, effective February 1, 2000.

17 The possible application of class actions to the Canadian mutual fund industry is discussed in Part VII of my 1996 paper entitled "Fiduciary Duties and Conflicts of Interest in the Canadian Mutual Fund Industry" in *Fiduciary Obligations: Implications for Financial Institutions and Funds* (Presentation to the Osgoode Hall Law School of York University Professional Development Programme, 2 October 1996).

18 This information is available on the Vanguard website at www.vanguard.com as of January 20, 2000.

19 This report is available on the Vanguard website at www.vanguard.com/catalog/lit/br_advantage.html.

20 A new report of the Technical Committee of IOSCO has been published entitled *Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators* (May 2000). The document is available in full on the IOSCO website at www.iosco.org.

## VI. MUTUAL FUND GOVERNANCE REFORMS IN OTHER JURISDICTIONS

In Part V of this report entitled "Survey of Mutual Fund Governance Structures" I described mutual fund governance regimes in existence in several jurisdictions. Reforms relating to governance regimes have recently been implemented, or are currently being recommended, in various jurisdictions. Some of the most relevant reforms, namely those that have taken place in Australia and those taking place in the United States, are discussed below. As well, a brief summary of the past and on-going work of IOSCO on this topic also is summarized below.

### 1. Australia

Of those jurisdictions surveyed for the purposes of this report, the newest governance regime in existence today is the one established in Australia in 1998.[1] This system was implemented following a comprehensive review by the Law Reform Commission of Australia ("ALRC") which was published in 1993 as Report No. 65 of The Companies and Securities Advisory Committee, entitled "Collective Investments: Other People's Money" (the "ALRC Report").[2]

The following overview of the new Australian legislation and of the background which points out some of the "to-ing and fro-ing" behind it was prepared by Pamela Hanrahan, Senior Lecturer, Faculty of Law, University of Melbourne in her book "Managed Investments Law"[3] and is reprinted with permission of the author.

"The creation and operation of managed investment schemes are regulated under relevant provisions of the Corporations Law (including Chapter 5C)…Chapter 5C commenced on 1 July 1998 and … represents a substantial departure from the previous regulatory approach and does not have any direct parallel in any major commercial jurisdiction. [The Corporations Law] defines managed investment as schemes to which participants contribute money or money's worth that is pooled, or used in a common enterprise, to produce financial or proprietary benefits, in which the investors do not have day to day control over the operation of the scheme. Generally speaking, such schemes are regulated if they have (or a group of associated schemes has) at least 20 members or are promoted by a person in the business of promoting managed investment schemes. However, [Chapter 5C] does not apply to schemes that are themselves bodies corporate, to superannuation, banking or life insurance products (at least directly) where all issues of interests in the scheme were excluded issues within the meaning of section 66. …

<u>The Regulatory Structure</u>

…Chapter 5C requires that managed investment schemes to which it applies be registered with ASIC [Australian Securities and Investments Commission]. Registered schemes must be operated by a single 'responsible entity' that is a public company holding a dealers licence and (at least where it holds scheme property) that acts as trustee for scheme members. The responsible entity is accountable to members for the conduct of the scheme and may be liable to members for the acts and omissions of any agents it appoints.

Schemes must be constituted under a constitution that complies with the requirements of Chapter 5C. The responsible entity must have a 'compliance plan' in accordance with which the scheme is operated, and its compliance with that plan must be audited annually and, unless the responsible entity has a board with a majority of independent members, that plan must be monitored by a 'compliance committee'. Responsible entities, their officers, employees and compliance committee members are subject to statutory duties in relation to the conduct of the scheme and investors and ASIC (the lead regulator of management investment schemes) have substantial statutory enforcement rights.

<u>History</u>

Chapter 5C was introduced into the Corporations Law on 1 July 1998 by the *Managed Investments Act* 1998. It replaced the former Divisions 5 and 5A of Part 7.12, which had regulated the offer and issue of 'prescribed interests'. Division 5 of Part 7.12 was based in significant part on predecessor legislation derived from Division 5 of Pt. IV of the *Uniform Company Acts* of 1961, and required that each prescribed interest scheme be constituted under an 'approved deed' containing prescribed covenants (including a buy-back obligation), be managed by a manager that was a public company holding a dealers licence, and supervised by an independent trustee or representative approved for that purpose by the predecessor bodies to ASIC.

Following the high profile collapses of some widely held unlisted property trusts in 1990, the Attorney General requested the Australian Law Reform Commission ('ALRC') and Companies and Securities Advisory Committee ('CASAC') to undertake a review of the legislation regulating prescribed interest schemes. The review process began with the release in September 1991 of ALRC/CASAC *Issues Paper 10*, dealing with all publicly offered investment products, including superannuation. However, almost immediately, superannuation was separated out of the inquiry. …

ALRC/CASAC *Discussion Paper 59*, dealing with collective investments regulated under the prescribed interest provisions of the Corporations Law, was released in 1992 and the final report, Report No 65, entitled *Collective Investments: Other People's Money,* accompanied by draft legislation, was released in 1993. ALRC/CASAC concluded that the dual entity structure mandated by statute [i.e., a manager and an independent trustee] resulted in a displacement of responsibility and was an inefficient structure to promote compliance. Their key recommendations for reform included:

- that the requirement to have a separate manager and trustee be abolished and replaced with a single, clearly identified entity responsible to investors and to public authorities for running the scheme

- that the responsible entity 'have a clear set of obligations, prescribed by law, that it owes directly to the investors in the scheme. These would include the obligation to act honestly in all matters concerning the scheme and to prefer the interests of the investors to its own interests in all matters concerning the scheme' (*Report No 65*, Summary, para 11)

- that the responsible entity have a majority independent board, owing clear obligations to investors

- that good compliance practices be ensured, through making a compliance plan a condition of a licence and a defence to liability for breach of duty

- that the regulator be given enhanced surveillance powers, and that auditors be required to report on breaches of the Corporations Law, the scheme constitution or the compliance plan
- that the requirement for an approved deed containing prescribed covenants be replaced with the requirement to have an enforceable constitution the provisions of which are not inconsistent with the statute
- that disclosure requirements be expanded
- that scheme operators be subject to minimum capital requirements
- that mandatory buy-back be abolished
- that investors' access to remedies, particularly for oppression, be expanded, and
- that investors have the right to replace the operator of the scheme, to wind up the scheme, and to amend its constitution.

Following receipt of *Report No 65*, the Attorney-General's Department released a Draft Bill and Commentary in December 1995. The 1995 Bill adopted the Report's recommendation for a single responsible entity but in a number of respects departed substantially from the approach taken by ALRC/CASAC. In particular, the requirement for a majority independent board was removed, along with the proposed oppression remedy and members' statutory rights to take action against directors of the responsible entity and others involved in a contravention of the Law. The compliance plan was made a source of legal obligations, rather than a condition of obtaining a licence or a defence to liability. The concept of a compliance committee and of separate auditors of the compliance plan were introduced. The capital adequacy requirements were removed, and the requirement for an external custodian introduced.

The 1995 Bill was due to be introduced into Federal Parliament early in 1996, however a Federal election was called for March 1996 and the legislation went into abeyance. Following the resulting change in Government a number of policy issues addressed in the 1995 Bill, including the proposal to abolish the requirement for a separate trustee, were re-opened. The ongoing debate delayed parliamentary consideration of the Bill. However in April 1997 the final report of the Financial System Inquiry recommended that the structure of collective investments be brought into line with that for superannuation funds, by introducing a requirement for a single responsible entity (Financial System Inquiry Final Report Recommendation 89).

In August 1997 the Treasurer announced major reform to the prescribed interest provisions of the Corporations Law, and legislation in substantially the same form as the 1995 Bill, but without the requirement for a separate custodian, was introduced into the Parliament in December 1997 and passed by the lower house on 4 March 1998. The Bill was then referred to the Joint Committee on Corporations and Securities, which late in March 1998 recommended that the Bill be passed in its current form. It was passed by the Senate with some amendments on 23 June 1998, and the amendments (including reinstatement of the capital adequacy requirements for responsible entities) adopted by the House of Representatives on 26 June 1998.

<u>Overview</u>

The key elements of the regulatory scheme established by Chapter 5C are as follows:

- Registration: Schemes that fall within the definition of managed investment scheme and that have issued interests in circumstances requiring a prospectus must be registered with ASIC in accordance with Part 5C.1 of the Law, unless the scheme (or a group of related schemes) has less than 20 members and is not promoted by a professional promoter. To obtain registration:

    Responsible Entity: The scheme must have a responsible entity that is a public company and that holds a dealers licence authorizing it to operate the scheme. Where it holds scheme property, and possibly in all cases, the responsible entity is a trustee for members.

    Constitution: The scheme must have a legally binding constitution that deals with the matters prescribed by the legislation.

    Compliance plan: The scheme must have a compliance plan that deals with the matters prescribed by the legislation.

Operating an unregistered scheme (where registration is required) is a contravention… and a contract to acquire interests in such a scheme is voidable at the option of the acquirer…

The remaining provisions of Chapter 5C go on to regulate the operation of registered schemes. The key requirements include:

- Statutory duties: The responsible entity, its officers and any compliance committee members are subject to statutory duties of honesty, care and loyalty in the conduct of the scheme. In addition the responsible entity and its officers are subject to express statutory obligations governing the operation of the scheme. Employees of the responsible entity are subject to statutory duties of loyalty.

- Members' voting rights: Members have the right to remove and replace the responsible entity, veto changes to the constitution (other than changes that the responsible entity reasonably considers will not adversely affect members' rights), veto certain financial benefits to the responsible entity or its related parties out of scheme property, and direct the responsible entity to wind up the scheme.

- Compliance monitoring: An auditor must be appointed to audit compliance with the compliance plan annually. Unless the responsible entity has a majority independent board, a compliance committee must be established to monitor compliance with the compliance plan.

ASIC has the power to modify or grant exemptions from compliance with Chapter 5C and has exercised this power extensively.

Responsible entities are subject to other statutory obligations in the conduct of registered schemes that are not contained in Chapter 5C. These include obligations:

- attaching to its securities dealers licence
- relating to members' meetings
- to maintain a register of members
- to appoint an auditor for the scheme, and have the scheme accounts audited
- relating to financial records and reporting
- relating to annual returns
- under securities regulation and continuous disclosure law
- to allow members access to scheme books
- on the responsible entities of listed schemes, to comply with the ASX Listing Rules
- on the directors of responsible entities of listed schemes, to disclose to ASX their interest in the scheme"[4]

Thus, we see that Australia has made a comprehensive review of the manner in which mutual funds are managed and has followed up that review by recently implementing a new set of rules relating to fund governance.

## 2. United States

The most detailed mutual fund governance system in existence among the surveyed jurisdictions, and not surprisingly the one that the Canadian mutual fund industry hears most about, is the one found in the United States for investment companies (which is the 1940 Act term for mutual funds). It is interesting that this regime, which has as its core a requirement for each investment company to have a board of directors comprised of at least 40% independent directors, has been in place since 1940 yet recommendations have been made in the past and continue to be made currently to implement additional procedures in order to make the U.S. regime an even stronger system from the governance perspective. For example, numerous recommendations were made by the Division of Investment Management of the SEC in May 1992 in its comprehensive report entitled "Protecting Investors: A Half Century of Investment Company Regulation".[5] In February 1999, SEC Chairman Levitt announced at a two day roundtable at the SEC devoted to mutual fund governance (the "Roundtable") that he would ask the SEC to make "improved investment company governance one of its top priorities".[6] At the end of the Roundtable, Chairman Levitt requested that the Director of the Division of Investment Management provide the Chairman with recommendations relating to fund governance within 30 days.[7] These recommendations were to be the beginning of an ongoing process that the SEC would use to try to improve fund governance in the United States. Within 30 days of that conference, Chairman Arthur Levitt proposed four reforms to the U.S. structure that, according to the SEC, would "enable independent fund directors to better protect and serve fund shareholders". [8] The four proposals as set out in the SEC press release were:

> "1. Require fund boards to have a majority of independent directors;
>
> 2. Require independent directors to nominate new independent directors;
>
> 3. Require that outside counsel for directors be independent from management to ensure that directors get objective and accurate information; and
>
> 4. Require that fund shareholders have more specific information on which to judge the independence of their fund directors." [9]

In its press release announcing these proposals, Chairman Levitt was quoted as follows:

> "These four straightforward proposals form the cornerstone of a major Commission effort to improve mutual fund governance. While these initial measures would be the most significant changes in a generation, this is just the beginning. The Commission will act on these measures immediately and will continue to mine the wealth of suggestions from the roundtable for additional reforms to pursue." [10]

Chairman Levitt also was quoted as follows:

> "Whether shareholders realize it or not, how directors fulfil their responsibilities affect them every day. *From negotiating and overseeing fund fees, to monitoring performance, to policing potential conflicts of interest, fund directors should be on the front lines in defense of the shareholder interest. They need to have the tools, the access and the power to faithfully fulfil their legal duty and moral mandate as the shareholder's representative.*" [11] [emphasis added]

In its press release, the SEC noted that Chairman Levitt also encouraged the mutual fund industry to employ various reforms, including:

> " Industry should develop measures to enhance the role of independent directors;
>
> Fund directors and investment advisers should consider being covered by separate insurance policies which will protect independent directors if they are sued by the investment adviser;
>
> Fund directors should more closely scrutinize fund brokerage as it relates to soft dollars and best execution; and
>
> Working with the Commission, fund directors should explore ways to improve disclosure to shareholders, such as the effects of taxes on their investments."[12]

The SEC concluded the press release by describing the following longer term issues:

> "Chairman Levitt noted several other issues raised at the roundtable that require more careful study and thoughtful discussion by the Commission and the industry including: independent directors' roles in connection with funds' distribution arrangements, advisory contracts, and valuation procedures.
>
> In closing, Chairman Levitt said, 'You can count on the Commission to do its part. But, it would be unfortunate if those were the only footsteps of action that mutual fund investors hear. *Effective and accountable fund governance reduces the opportunity for people to say that the industry is incapable of looking after the interests of its investors. I believe all of us recognize a central truth: enhancing independent director effectiveness is good for investors. And what's good for investors is good for business.'* "[13] [emphasis added]

Following the Roundtable at the SEC, the ICI (which is the national association of the U.S. investment company industry, including among its members over 7500 mutual funds with assets of approximately US$5.86 trillion as of June 1999, accounting for approximately 95% of total industry assets with over 73 million individual shareholders) announced the creation of an Advisory Group on Best Practices for Fund Directors (the "Advisory Group").[14] The mission of the Advisory Group was to identify the best practices used by fund boards to enhance the independence and effectiveness of investment company directors and to recommend those practices that should be considered for adoption by all fund boards. On June 24, 1999, the Advisory Group issued the ICI Best Practices Report. The report recommended a series of policies and practices that go beyond what is legally required. According to the report, the policies and practices

> "are designed to enhance the role of investment company directors. Many of these recommendations are already in use by many fund boards. The recommendations are designed to ensure that the outside directors are independent from the fund's investment adviser, principal underwriter and their affiliates, and to enhance the effectiveness of all fund directors in fulfilling their oversight responsibilities."[15]

The 15 specific recommendations of the Advisory Group are as follows:

"1. Super-Majority of Independent Directors

The Advisory Group recommends that at least two-thirds of the directors of all investment companies be independent directors.

2. Persons formerly Affiliated with the Adviser, Principal Underwriter and Certain Affiliates

The Advisory Group recommends that former officers or directors of a fund's investment adviser, principal underwriter or certain of their affiliates not serve as independent directors of the fund.

3. Control of the Nominating Process by Independent Directors

   The Advisory Group recommends that independent directors be selected and nominated by the incumbent independent directors.

4. Compensating Independent Directors

   The Advisory Group recommends that independent directors establish the appropriate compensation for serving on fund boards.

5. Fund Ownership Policy

   The Advisory Group recommends that fund directors invest in funds on whose boards they serve.

6. Qualified Independent Counsel and Other Experts

   The Advisory Group recommends that independent directors have qualified investment company counsel who is independent from the investment adviser and the fund's other service providers. The Advisory Group also recommends that independent directors have express authority to consult with the fund's independent auditors or other experts, as appropriate, when faced with issues that they believe require special expertise.

7. Annual Questionnaire on Relationships with the Adviser and Other Service Providers

   The Advisory Group recommends that independent directors complete on an annual basis a questionnaire on business, financial and family relationships, if any, with the adviser, principal underwriter, other service providers and their affiliates.

8. Organization and Operation of the Audit Committee

   The Advisory Group recommends (1) that investment company boards establish Audit Committees composed entirely of independent directors; (2) that the Audit Committee meet with the fund's independent auditors at least once a year outside the presence of management representatives; (3) that the Audit Committee secure from the auditor an annual representation of its independence from management; and (4) that the Audit Committee have a written charter that spells out its duties and powers.

9. Separate Meetings of the Independent Directors

The Advisory Group recommends that independent directors meet separately from management in connection with their consideration of the fund's advisory and underwriting contracts and otherwise as they deem appropriate.

10. Lead Independent Director or Directors

The Advisory Group recommends that independent directors designate one or more 'lead' independent directors.

11. Insurance Coverage and Indemnification

The Advisory Group recommends that fund boards obtain directors' and officers'/errors and omissions insurance coverage and/or indemnification from the fund that is adequate to ensure the independence and effectiveness of independent directors.

12. Unitary or Cluster Boards

The Advisory Group recommends that investment company boards of directors generally be organized either as a unitary board for all the funds in a complex or as cluster boards for groups of funds within a complex, rather than as separate boards for each individual fund.

13. Retirement Policy

The Advisory Group recommends that fund boards adopt policies on retirement of directors.

14. Evaluation of Board Performance

The Advisory Group recommends that fund directors evaluate periodically the board's effectiveness.

15. Orientation and Education

The Advisory Group recommends that new fund directors receive appropriate orientation and that all fund directors keep abreast of industry and regulatory developments."[16]

The SEC recently published for comment[17] proposed amendments (the "Proposed Rules") to certain exemptive rules under the *Investment Company Act of 1940* to require that, for investment companies that rely on those rules: independent directors constitute at least a majority of their board of directors; independent directors select and nominate other independent directors; and any legal counsel for the independent directors be independent legal counsel. The SEC also proposed amendments to rules and forms to improve the disclosure that investment companies provide about their directors. According to the SEC, these proposed amendments are designed to enhance the independence and effectiveness of boards of directors of investment companies and to better enable investors to assess the independence of directors.

The SEC is proposing to require that, for funds relying on certain exemptive rules:

- independent directors constitute either a majority or a super-majority (two-thirds) of the fund's board of directors;
- independent directors select and nominate other independent directors; and
- any legal counsel for the fund's independent directors be independent legal counsel.

Second, the SEC is proposing rules and rule amendments that would:

- prevent qualified individuals from being unnecessarily disqualified from serving as independent directors;
- protect independent directors from the costs of legal disputes with fund management;
- permit the SEC to monitor the independence of directors by requiring funds to keep records of their assessments of director independence;

- temporarily suspend the independent director minimum percentage requirements if a fund falls below a required percentage due to an independent director's death or resignation; and
- exempt funds from the requirement that shareholders ratify or reject the directors' selection of an independent public accountant, if the fund establishes an audit committee composed entirely of independent directors.

Finally, the SEC is proposing to require funds to provide better information about directors, including:

- basic information about the identity and business experience of directors;
- fund shares owned by directors;
- information about directors' potential conflicts of interest; and
- the board's role in governing the fund's operations.

In the Proposed Rules, the SEC has endorsed the sentiments of the Roundtable participants who favour enhancing the effectiveness and independence of fund boards of directors. Therefore the SEC is proposing rule amendments designed to reaffirm the important role that independent directors in the U.S. play in protecting fund investors, strengthen their hand in dealing with fund management, reinforce their independence, and provide investors with better information to assess the independence of directors.

The following is a summary of some key components of the Proposed Rules.

**(a) Enhancing the Independence of Fund Boards of Directors**

The Proposed Rules will amend ten exemptive rules (the "Exemptive Rules") under the 1940 Act to enhance the independence of fund directors who are charged with overseeing the fund's activities and transactions covered by those rules. The ten Exemptive Rules: (i) exempt funds or their affiliated persons from provisions of the Act, and (ii) have as a condition the approval or oversight of independent directors. These amendments would require, for funds that rely (or whose affiliated persons rely) on the Exemptive Rules, that: (i) independent fund directors constitute either a majority or a super-majority (two-thirds) of their boards; (ii) independent fund directors select and nominate other independent directors; and (iii) any legal counsel for the independent fund directors be independent legal counsel. The Exemptive Rules are discussed in further detail in Part VII of this report under the heading "1. Recommendations Regarding Establishing an Independent Governing Body".

**(1) Percentage of Independent Directors**

(i) Proposed Board Composition Requirements

As discussed above, the Advisory Group's report recently endorsed boards having a "super-majority" of independent directors. The SEC proposes to amend the Exemptive Rules to require funds relying on them to have boards with at least a majority of independent directors. The SEC has requested comments on whether the SEC should adopt a simple majority requirement or the two-thirds super-majority requirement recommended by the Advisory Group. The SEC also has requested comments as to whether an even higher percentage requirement (*e.g.*, 75 percent or 100 percent) should be adopted. If the proposed amendments are adopted, the SEC expects to delay the compliance date for one year.

(ii) Suspension of Board Composition Requirements

If the death, disqualification, or bona fide resignation of an independent director causes the representation of independent directors on the board to fall below that required under the 1940 Act, section 10(e) of the 1940 Act suspends the percentage requirement for a short time to allow the vacancy to be filled. In the SEC's experience, the time provided by section 10(e) is insufficient for most funds to select and nominate qualified independent director candidates, and, if necessary, hold a shareholder election.

The SEC is proposing new rule l0e-l to address these concerns which would suspend the board composition requirements of the 1940 Act, and of the rules under the 1940 Act, for 60 days if the board of directors may fill the vacancy or 150 days if a shareholder vote is required.

**(2) Selection and Nomination of Independent Directors**

According to the SEC, independent directors who are truly independent are more effective in their roles as "watchdogs" for fund shareholders. While the 1940 Act precludes independent directors from having certain affiliations or relationships with the fund's adviser or principal underwriter, no law can guarantee that an independent director will be vigilant in protecting fund shareholders. Fund shareholders therefore must depend on the character, ability and diligence of persons who serve as fund directors to protect their interests. The Advisory Group has recommended the self-selection and self-nomination of independent directors.

The SEC is proposing to amend each of the Exemptive Rules to require that funds relying on those rules have boards whose independent directors select and nominate other independent directors. Funds whose independent directors were not nominated in this manner would not immediately lose their ability to rely on the Exemptive Rules. Rather, if the proposed amendments are adopted, these funds would be required to adopt the practice before the compliance date for the amendments, and the fund's incumbent independent directors subsequently would select and nominate all independent directors of the fund.

**(3) Independent Legal Counsel**

According to the SEC, another recognized method of enhancing the independence and effectiveness of independent directors is to provide them with independent counsel. The SEC believes counsel who does not also represent the fund's adviser can best provide zealous representation of independent directors. The recent Advisory Group report recommended that independent directors have qualified counsel who is independent from the fund's adviser and other service providers.

The SEC is not, however, proposing to require that independent directors have their own legal counsel. Although the SEC believes that independent directors are in the best position to fulfill the roles assigned to them by the Exemptive Rules if they have the assistance of independent counsel, the SEC recognizes that the services of counsel do not come without cost. Rather, the proposed amendments require that reliance on each of the Exemptive Rules would be conditioned on any legal counsel for a fund's independent directors being "independent legal counsel." A person would be an "independent legal counsel" if the fund reasonably believes the person and his law firm, partners, and associates have not acted as legal counsel for the fund's investment adviser, principal underwriter, administrator (collectively, "management organizations"), or any of their control persons at any time since the beginning of the fund's last two completed fiscal years. The independent directors could make an exception and permit a person to serve as independent legal counsel even if the person has a remote or minor conflict of interest because the person has provided legal advice to management organizations or their control persons.

**(b) Joint Insurance**

Funds typically purchase "errors and omissions" insurance policies to cover expenses incurred by directors and officers in the event of litigation. Often these policies are joint policies that cover numerous funds within a fund family as well as the adviser and principal underwriter of those funds. Although the 1940 Act and SEC rules generally prohibit joint transactions and other joint arrangements involving a fund and its affiliates, rule 17d-1(d)(7) permits the purchase of joint D&O/E&O policies.

Joint D&O/E&O policies historically have excluded claims in which the parties under the policy sue each other. A policy that insures both a fund's investment adviser and its independent directors therefore may not cover the independent directors' expenses of litigation with the fund's adviser. Without this coverage, independent directors face substantial personal legal expenses in the event of a lawsuit. As the SEC is concerned about the effect that these exclusions may have on the ability of independent directors to carry out their statutory responsibilities, the SEC is proposing to amend rule 17d-1(d)(7) to make it available only for policies that do not exclude coverage for litigation between the independent directors and the fund's adviser.

### (c) Ratification of Independent Public Accountant for Funds with Independent Audit Committees

The SEC is proposing a rule that would exempt a fund from the 1940 Act's requirement that shareholders ratify or reject the selection of the fund's independent public accountant if the fund has an audit committee comprised wholly of independent directors. In order for a fund to rely on the proposed exemption, (i) the audit committee must be responsible for overseeing the fund's accounting and auditing processes, (ii) the fund's board of directors must adopt an audit committee charter setting forth the committee's structure, duties, powers, and methods of operation, and (iii) the fund must maintain a copy of the charter.

### (d) Qualification as an Independent Director

The 1940 Act sets standards for who may be considered an independent director. While these standards are meant to exclude individuals with affiliations or business interests that can impair their independence, there are circumstances in which the standards may cause certain individuals to be unnecessarily disqualified from serving as an independent director. The SEC is proposing to remove certain obstacles that may disqualify certain persons from acting as independent directors.

**(e) Disclosure Proposals**

The SEC believes that shareholders have a significant interest in knowing who the independent directors are, whether the independent directors' interests are aligned with shareholders' interests, whether the independent directors have any conflicts of interest, and how the directors govern the fund. This information helps a mutual fund shareholder to evaluate whether the independent directors can, in fact, act as an independent, vigorous and effective force in overseeing fund operations. Currently, information about directors is available in fund registration statements and proxy statements for the election of directors. Generally, funds are required to provide basic information about directors in the statement of additional information ("SAI") and proxy statements, including: name and age; positions with the fund; principal occupations during the past five years; and compensation from the fund and fund complex. Moreover, funds are required to disclose in proxy statements for the election of directors a director's positions with, interests in, and transactions with, the fund and certain persons related to the fund.

The SEC has concluded that, while its fundamental approach to disclosure requirements is sound, there are several gaps in the information that shareholders currently receive about directors. Historically, the primary vehicle for providing information about mutual fund directors was the proxy statement prepared in connection with shareholder meetings. In recent years, the proxy statement has become an ineffective vehicle for communicating information to fund shareholders on a regular basis because funds generally are no longer required to hold annual meetings. Therefore, the SEC is proposing amendments to its disclosure rules to close these gaps. The proposals would require mutual funds to:

- Provide basic information about directors to shareholders annually so that shareholders will know the identity and experience of their representatives;
- Disclose to shareholders fund shares owned by directors to help shareholders evaluate whether directors' interests are aligned with their own;
- Disclose to shareholders information about directors that may raise conflict of interest concerns; and
- Provide information to shareholders on the board's role in governing the fund.

The SEC is proposing to modify disclosure of matters related to the board's role in governing a fund currently required in the proxy rules and the SAI. The SEC believes that this information would help shareholders more readily determine whether the directors are effectively representing shareholders' interests, independent of fund management. The proxy rules require a mutual fund to discuss in reasonable detail the material factors and conclusions that formed the basis for the board of directors' recommendation that the shareholders approve an investment advisory contract, including a discussion of any benefits derived or to be derived by the investment adviser from the relationship with the fund such as soft dollar arrangements by which brokers provide research to the fund or its investment adviser in return for allocating fund brokerage. The SEC is proposing to require similar disclosure in the SAI so that investors will be able to evaluate the board's basis for approving the renewal of an existing investment advisory contract.

The SEC also is proposing to modify disclosure in the proxy rules and the SAI relating to a fund's committees of the board of directors. The proxy rules currently require mutual funds to disclose information about standing audit, nominating and compensation committees. In the SAI, mutual funds are required to identify members of any executive or investment committee and provide a concise statement of the duties and functions of each committee. The SEC is proposing to modify this disclosure to require mutual funds to identify each standing committee of the board in the SAI and proxy statements for the election of directors. As in the current proxy rules, funds would be required to: provide a concise statement of the functions of each committee; identify the members of the committee; indicate the number of committee meetings held during the last fiscal year; and state whether its nominating committee will consider nominees recommended by fund shareholders and, if so, describe the procedures for submitting recommendations.

As I noted above, these Proposed Rules have not been finalized and a request for comments was published by the SEC with a deadline of January 28, 2000.

**3. IOSCO**

IOSCO is comprised of a group of member agencies which have resolved to, among other things, cooperate to promote high standards of regulation in order to maintain just, efficient and sound markets. The Executive Committee of IOSCO has established the Technical Committee of IOSCO, which is made up of sixteen agencies that regulate some of the world's larger, more developed and internationalized markets. The objective of the Technical Committee is to review major regulatory issues related to international securities and futures transactions and to coordinate practical responses to these concerns. The Technical Committee has set up specialized working groups to address certain functional subject areas.[18]

In February 1993, the Technical Committee created a working group with a mandate to, among other things, identify equivalence in the regulatory framework for collective investment schemes. In 1994 the working group published a report[19] (the "1994 Report") which was adopted by the Technical Committee, in which the working group developed a set of core principles that are considered important by member countries for the regulation of such schemes.

I have excerpted certain core principles relating to mutual fund governance cited in the 1994 Report:

"Eligibility to act as an Operator

The regulatory regime should impose standards of conduct and minimum eligibility standards that require approval by the regulatory authority prior to commencement of marketing of a CIS [collective investment scheme or schemes, as the context may require]. The degree of restrictions imposed on eligibility will be likely to vary according to the overall context of collective investment regulation, including the extent of ongoing regulation of CIS transactions and the existence of independent monitoring systems. To the extent that a regulatory regime imposes specific requirements, they should include the following:

(a) Honesty and Fairness

An operator should observe high standards of integrity and fair dealing while acting in the best interest of a CIS. High standards of market conduct should be maintained. In addition to its investment responsibilities, the operator should also ensure that the assets of a CIS are adequately protected and segregated.

(b) Capability

An operator should have sufficient human and technical resources to ensure that it is capable of carrying out the necessary functions of fund management.

(c) Capital Adequacy

An operator should at all times maintain adequate financial resources to meet its investment business commitments and to withstand the risks to which its business is subject.

(d) Diligence and Effectiveness

An operator should act with due skill, care and diligence and employ effectively the resources and procedures which are needed for the proper performance of the schemes. An operator must organise and control its internal affairs in a responsible manner, with proper records and adequate arrangements for ensuring that employees are suitable, adequately trained and properly supervised. There should be well defined procedures in place to ensure compliance with regulations and all operators should deal with regulators in an open and co-operative manner.

(e) Operator Specific Powers and Duties

An operator has a duty to make decisions as to the investment portfolio structure and administrative procedures of the CIS so as to secure its objectives. The operator must not exceed the powers conferred on it by the CIS's constituting documents or particulars.

(f) Compliance

Operators and schemes must meet strictly defined standards as set by the regulatory authority, for both initial approval and continuing operation.

<u>Supervision</u>

The regulatory regime must provide for a regulatory authority to take overall responsibility for the supervision of CIS authorised within its jurisdiction.

(a) Registration and Authorisation

A CIS must be registered with or authorised by the regulatory authority prior to commencement of marketing of its units. That process may take the form of document filing, CIS registration or approval of the parties to the CIS (such as the operator and custodian) as appropriate to the overall regulatory system.

(b) Inspections and Investigations

The regulatory authority should have the means to investigate conduct relating to CIS, including the power to conduct on-site inspections. These inspections may be carried out by the authority itself or its delegate (which may be the CIS's auditor).

(c) Powers of the Regulatory Authority

The regulatory authority should have adequate powers to protect investors' interests, including but not limited to revoking an operator's licence, freezing CIS assets or the operator's assets, taking action to withdraw the CIS's authorisation or stop the use of a prospectus, instituting administrative or civil proceedings, and recommending criminal action where appropriate.

(d) Third Party Supervision

The regulatory regime may provide for an independent third party or parties (in addition to the regulatory authority) to supervise the activities of the operator and any other parties involved in CIS activities.

Conflicts of Interest

The regulatory regime should recognise that an operator of a CIS may have interests that if exercised without restraint would conflict in a material way with the interests of investors. Regulatory authorities should respond to this risk by ensuring that a regime provides for the exercise of management responsibilities with full regard to the best interests of investors. Such a regime may be general in nature, relying on the concept of "fiduciary responsibility" as interpreted domestically. Equally the establishment of detailed regulations designed to monitor potential conflicts between operator and investors is recognised as an acceptable regulatory method.

(a) Possible Conflict of Interest Situations

Whether the concept of overall fiduciary responsibility is utilised, or provisions exist for detailed rules to monitor potential conflicts, a regulatory regime must be capable of dealing with certain situations which may give rise to conflicts of interest. They include (but may not be limited to):

(i) principal transactions between a CIS and its affiliates (including affiliates of the operator and custodian);

(ii) transactions where a CIS and its affiliates jointly participate;

(iii) soft commissions;

(iv) lending or borrowing to or from affiliates;

(v) purchase of affiliates' securities;

(vi) purchase of securities underwritten by affiliates;

(vii) use of affiliated brokers; and

(viii) employees' transactions for their own account.

(b) General Duties & Obligations

Possible conflict of interest situations may be addressed by the following:

(i) the duty of an operator to act in best interests of investors; and

(ii) the power of the regulatory authority to impose sanctions for self-dealing, such as revoking the operator's licence, taking action to withdraw a CIS's authorisation or stop the use of a CIS's prospectus, freezing the assets of the operator, instituting administrative or civil proceedings, and recommending criminal action where appropriate.

(c) Specific Regulatory Response

In addition to general duties and obligations, the means available to control conflict of interest situations (to the extent that they may arise within the regulatory framework of a particular jurisdiction) include all or a combination of some of the following:

(i) direct prohibition under the law;

(ii) a precise code of business conduct either established by the regulatory authority, or a code established by a practitioner's organisation, which is approved and enforced by the regulatory authority;

(iii) review and/or approval of certain transactions and activities by the regulatory authority;

(iv) surveillance of operators by the regulatory authority;

(v) disclosure by the operator;

(vi) record keeping by the operator;

(vii) limitation of the activities of the operator; or

(viii) independent review by a third party.

Investor Rights

The regulatory regime should provide investors with certain rights in relation to a CIS, which are appropriate to the overall context of CIS regulation. A fundamental right of an investor in a CIS is the right to withdraw funds from the CIS within a reasonable period. The regime should also enable investors to participate in significant decisions concerning the CIS to the extent applicable under the structure of the CIS, or for the regulatory authority or another third party to have the capacity to act in the interests of investors.

(a) Redemption Conditions

(i) At the outset of the participation investors in a CIS must be fully informed through the prospectus of the charging of redemption and management fees.

(ii) Units of CIS must be repurchased or redeemed at the request of any unit holder, in a manner which does not give an unfair advantage to one investor in the CIS over any other investor. The regulatory regime should ensure that investor rights are maintained in the event of a major change in the activities of the CIS.

(b) Access To Remedies

In addition to the normal access to legal procedures in the courts, investors should be able to refer matters to the regulatory authority for consideration. The regulatory authority must have proper powers of investigation, means to review investment managers and should have adequate powers (as noted in Principle 5.3) to enforce its decisions on the operator and on the custodian in order to protect investor's interests.

(c) Investment Companies Only – Shareholder Powers

When a CIS is an investment company, investors should have the ability to participate in the affairs of the company through the exercise of a right to vote at periodic or special meetings of the shareholders."[20]

Since the publication of the 1994 Report, the Technical Committee of IOSCO has continued to publish documents relating to the regulation of collective investment schemes, including an international comparative table which provides information regarding the collective investment schemes of fifteen countries[21] and a report setting out principles for the supervision of operators of such schemes.[22] A working group of the Technical Committee has just completed compiling responses to a questionnaire on principles and best practice standards on infrastructure for decision making for scheme operators. In May 2000, IOSCO held its annual conference and, following that conference, new IOSCO publications with respect to collective investment schemes were published, including a report summarizing the responses to the questionnaire.[23]

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1 There have been changes to Japan's laws governing all investments funds which became effective December 1998. While these changes do impact on the governance regime in Japan, they do not constitute a substantive overhaul of the manner in which funds are governed in the same way that the new Australian model does.

2 Australia, Law Reform Commission and Companies and Securities Advisory Committee, Report No. 65: Collective Investments: Other People's Money (1993).

3 P. Hanrahan, *Managed Investments Law*, The Centre for Corporate Law and Securities Regulation and CCH Australia Limited (November 1998).

4 *Ibid*. at 2 - 6.

5 Division of Investment Management, United States Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (Washington, D.C.: U.S. Government Printing Office, May 1992) [hereinafter *Protecting Investors*]. *Protecting Investors* recommended, among other things, that the SEC should propose to amend the 1940 Act to permit the introduction of the Unified Fee Investment Company ("UFIC"). A UFIC would be organized and operated as a type of open-ended investment company that is operated by an investment manager in return for a single fixed fee. This fee structure, in which there are no sales charges or redemption fees and all expenses (except brokerage commissions on the UFIC's own portfolio transactions and extraordinary costs) are paid from the fee or the manager's own resources, would substitute market competition for the oversight role of boards of directors in the review of fee levels (*Protecting Investors* at 338-40). The UFIC was never introduced in the United States, nor was another, similarly innovative model, the Unitary Investment Fund ("UIF"). According to *Protecting Investors*, the UIF, which was originally proposed in 1980, is an optional form of investment company, similar to a trust, in which a single management fee would cover all expenses (except for extraordinary expenses and shareholder account services). Unlike the UFIC, the UIF would have no board of directors (*Protecting Investors* at 282-283).

[6] A transcript of the U.S. Securities and Exchange *Commission Roundtable Conference on the Role of Independent Investment Company Directors*, (Washington, D.C., 23-24 February 1999) can be found in full on the SEC website at www.sec.gov/offices/invmgmt/rountab.htm.

[7] *Ibid*.

[8] SEC press release, "SEC Chairman Arthur Levitt Proposes Significant Reforms to Mutual Fund Governance Structure" (22 March 1999).

[9] *Ibid*.

[10] *Ibid*.

[11] *Ibid*.

[12] *Ibid*.

[13] *Ibid*.

[14] *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (Investment Company Institute, 24 June 1999) (Chair: J. Brennan) at (i) of the Executive Summary.

[15] *Ibid* at (iii) of the Executive Summary.

[16] *Ibid*. at (iii) – (v) of the Executive Summary.

[17] "Role of Independent Directors of Investment Companies", Release Nos. 33-7754; 34-42007; IC-24082; File No. S7-23-99 (15 October 1999) [hereinafter *Proposed Rules*]. This summary of the *Proposed Rules* is excerpted in large part from the document that can be found, in its entirety, on the SEC website at www.sec.gov/rules/proposed/34-42007.htm.

[18] Summarized from the IOSCO website at www.iosco.org (as at December 16, 1999).

[19] Report of the Technical Committee of IOSCO, *Report on Investment Management - Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum* (October 1994). This document is available in full on the IOSCO website.

[20] *Ibid*. at 2-10.

[21] The international comparative chart is Part II of Report of the Technical Committee of IOSCO, *Report on Investment Management* (July 1995). This document is available in full on the IOSCO website.

[22] Report of the Technical Committee of IOSCO, *Principles for the Supervision of Operators of Collective Investment Schemes* (September 1997). This document is available in full on the IOSCO website.

[23] Two new reports of the Technical Committee of IOSCO which are now available are *Summary of Responses to the Questionnaire on Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators* (May 2000) and *Conflicts of Interests of CIS Operators* (May 2000). Both documents are available in full on the IOSCO website.

## VII. RECOMMENDATIONS

I do not believe that there is only one correct answer to the question of what mutual fund governance regime should be established in Canada. If there was but a single right answer, then one would think that the debate on mutual fund governance which began in Canada in 1969 with the publication of the seminal "Report of the Canadian Committee on Mutual Funds and Investment Contracts"[1] should have resulted in a definitive conclusion sometime during the last thirty years. In fact, there are various mutual fund governance regimes in existence today around the world.[2] I also understand that contemporaneously with the preparation of this report, IOSCO is reviewing mutual fund governance in many countries. Coincidentally, some systems are in the process of being reformed even as such review is being undertaken. There is no current worldwide consensus – nor is there even any consensus in Canada – that any one system of mutual fund governance is the best in comparison to others.

During my discussions in preparing this report, one person jokingly called me the "Moses" who had been retained by the CSA to guide us to the promised land. The concern was voiced that the CSA do not understand that we are in the promised land now and whatever recommendations I make may lead us in the wrong direction. I am not Moses nor for that matter am I an economist or a private investigator. The CSA and the mutual fund industry can decide for themselves what direction they believe the recommendations in this report will take us.

Some of my recommendations will require the enactment of new laws. Others, however, can be adopted voluntarily by the mutual fund industry or, if not adopted voluntarily, might in effect be forced upon members of the fund industry by the CSA denying exemptive relief unless the recommendations are adopted. The basis for the denial of the exemptive relief by the CSA would be that it is not in the public interest for the exemptive relief to be granted unless the fund organization has adopted those recommendations set out in this report which are accepted by the CSA.

With the foregoing in mind, I will now discuss my recommendations.

## 1. Recommendations Regarding Establishing an Independent Governing Body

I have discussed in this report the history of the mutual fund governance debate in Canada, publicly reported issues on the manager side of the mutual fund industry, potential positive benefits should a governance regime be implemented, types of mutual fund governance structures in existence elsewhere in the world and mutual fund governance reforms in other jurisdictions. The fundamental question is whether the current mutual fund governance system in Canada, which consists of a statutory standard of care and duty of loyalty as well as common law fiduciary duties, should be changed in some manner. I believe that changes should be made to the existing mutual fund governance system in Canada by mandating some type of independent governing body, in order: to maintain public trust and confidence in the mutual fund industry; to reduce the potential for abuses arising; to pre-empt potential litigation; to possibly loosen existing conflict rules, with the CSA relying on the governance mechanism to monitor transactions that otherwise would be prohibited or would require exemptions from existing securities laws; to not force investors to "vote with their feet"; to hopefully assist in obtaining better performance for investors; and to ensure that the interests of the securityholders of mutual funds are given prime importance with respect to decisions made in a mutual fund complex. I believe, to paraphrase Ira Millstein, that we do not need to try to prove mathematically that some form of governance regime is needed – there is a lot to be said in favour of staring at the piece of reality we are studying and asking just what is going on.[3] Again to paraphrase Mr. Millstein, there is no need to await definitive proof – it probably will never come, and it is not necessary.[4] Accordingly, I recommend that at this time each mutual fund complex should be required to establish a governance regime that has an independent governing body. The key question, however, is what type of independent governing body should be mandated.

I already have stated that I do not believe there is only one correct answer to the question of what governance regime should be established in Canada. There are various mutual fund governance regimes in existence today around the world and some systems currently are in the process of being reformed. To reiterate, there is no current worldwide consensus – nor is there even any consensus in Canada – that any one system of mutual fund governance is the best in comparison to others.

I also previously stated that the full panoply of U.S. style governance is not necessarily what is appropriate for Canada. As I indicated in Part IV of this report, it is interesting to see that there are reported problems today in the U.S. mutual fund industry that are very similar to issues discussed in the Canadian mutual fund industry, notwithstanding that the U.S. mutual fund industry has had as its underpinning for almost 60 years a requirement of boards of directors for investment companies. Because the U.S. is our largest and closest neighbour, and because much of what occurs in the U.S. financial industry is transported to Canada, it is not surprising that Canadian regulators, academics and lawyers make reference to the U.S. system of mutual fund governance. However, one also should keep in mind that the U.S. model, which has as its core a board of directors of each mutual fund, is, I believe, a mutual fund governance system which is unique in the world today and has not been mandated elsewhere.[5]

One should understand that designing a governance system is not a science but rather is an art. As Martin Lipton, a well-known U.S. lawyer, has stated in the corporate governance context:

> "There are some people who know what an ideal corporate governance world is. I don't."[6]

The 1969 Mutual Funds Report is the seminal report on the regulation of mutual funds in Canada and much of existing Canadian mutual fund regulation is based on its recommendations. The report did not recommend that boards of directors of mutual funds be mandated. The Committee that authored the 1969 Mutual Funds Report stated, however, that they supported the use of independent directors on a voluntary basis by mutual funds.[7]

Because there is no empirical evidence or consensus that one type of governance regime is better than others and because of the diversity in size and structure of mutual fund complexes in Canada, I believe that in an ideal world one specific form of governance regime would not be mandated today. In an ideal world a fund complex would be provided with the flexibility to determine the type of governance regime it wishes to adopt. The CSA could then monitor Canadian mutual fund complexes which have adopted different governance regimes and also monitor the mutual fund governance regimes that are recommended and implemented elsewhere in the world and, based upon the evidence garnered from such monitoring, decide at some future date to mandate a specific governance regime.

In this flexible model, the types of regimes that in theory could be established by a mutual fund complex include:

(a) a corporate trustee independent of the manager;

(b) a corporate trustee which is not independent of the manager but which has a governance committee of the board comprised of at least a majority of individuals who are independent of the manager;

(c) a governance committee of the board of directors of the manager, comprised of at least a majority of individuals who are independent directors;

(d) an advisory board (of directors, governors or trustees, as the case may be) of each mutual fund or of a group of mutual funds comprised of at least a majority of individuals who are independent; or

(e) a "corporate style" board (of directors, governors or trustees, as the case may be) of each mutual fund or of a group of mutual funds comprised of at least a majority of individuals who are independent.

Again, in an ideal world, the recommendations relating to a corporate style board set out in the next portion of this Part VII under the heading "2. Recommendations Regarding a Specific Governance Regime" could be used as guidelines and applied, to the extent applicable and with appropriate changes, to the type of governance regime established by the mutual fund complex.

In this theoretical model where the CSA do not mandate a specific governance regime at this time but rather permit each mutual fund complex to choose the type of regime it wishes to follow for the time being, the CSA could consider whether to provide certain types of relief from existing regulatory constraints only to mutual fund organizations that adopt a specific form of governance regime. For example, if mutual fund complexes seek exemptive orders in connection with the existing conflicts rules or in connection with the requirements of National Instrument 81-102, the CSA could consider preconditioning such relief on the mutual fund complex adopting a "preferred" form of governance regime. This opt in procedure would create an incentive for mutual fund organizations to adopt a specific type of governance regime and would therefore cause the mutual fund organizations to weigh the benefits of the proposed relief against any detriments relating to the adoption of this specific form of governance regime.

Such an opt in procedure is discussed in the SEC's recent release relating to the role of independent directors of investment companies,[8] with respect to which the SEC requested comments by January 28, 2000. In connection with the SEC's proposed rules to reform the U.S. mutual fund governance regime described in this release, the SEC stated as follows:

> "Our proposals to enhance board independence would amend ten rules under the Investment Company Act. We have selected those rules that (i) exempt funds or their affiliated persons from provisions of the Act, and (ii) have as a condition the

approval or oversight of independent directors. For convenience, we will refer to these rules as the "Exemptive Rules". The Exemptive Rules typically relieve funds from statutory prohibitions that preclude certain types of transactions or arrangements that would involve serious conflicts of interest. In one case, a rule permits the board to approve an interim advisory agreement without a shareholder vote that otherwise would be required. Based on these criteria, we propose to amend the following rules:

- Rule 10f-3 (permitting funds to purchase securities in a primary offering when an affiliated broker-dealer is a member of the underwriting syndicate);
- Rule 12b-1 (permitting use of fund assets to pay distribution expenses);
- Rule 15a-4 (permitting fund boards to approve interim advisory contracts without shareholder approval);
- Rule 17a-7 (permitting securities transactions between a fund and another client of the fund's adviser);
- Rule 17a-8 (permitting mergers between certain affiliated funds);
- Rule 17d-1(d)(7) (permitting funds and their affiliates to purchase joint liability insurance policies);
- Rule 17e-1 (specifying conditions under which funds may pay commissions to affiliated brokers in connection with the sale of securities on an exchange);
- Rule 17g-1(j) (permitting funds to maintain joint insured bonds);
- Rule 18f-3 (permitting funds to issue multiple classes of voting stock); and
- Rule 23c-3 (permitting the operation of interval funds by enabling closed-end funds to repurchase their shares from investors).

The Commission requests comment on the criteria that we have used to select these rules. Are there additional rules that we should similarly amend? Conversely, should any of the Exemptive Rules not be amended?

Although the Commission urges all funds to adopt these measures to strengthen the independence of their boards, we are *not* proposing to require all funds to adopt these measures. Funds that do not rely on any of the Exemptive Rules will

> not be subject to these requirements. They may continue, for example, to have only 40 percent of their boards consist of independent directors."[9]

The measures referred to in the previous paragraph which the SEC is urging all mutual funds to adopt are described in Part VI of this report under the heading "2. United States – (a) Enhancing the Independence of Fund Boards of Directors". In short, however, the measures would require that: (i) independent fund directors constitute either a majority or super-majority (two-thirds) of their boards; (ii) independent fund directors select and nominate other independent directors; and (iii) any legal counsel for the independent fund directors be independent legal counsel.

The theoretical model which provides flexibility to mutual fund organizations to choose one of several types of independent governance regimes is, however, a model that I believe would cause difficulties in practice for various reasons, including the following:

- the public may be confused as to how the various governance systems will operate and perhaps even skeptical that the various fund governance models adequately respond to the reasons for adopting a governance system;
- it will not be easy for the CSA to monitor, compile empirical evidence and evaluate the efficacy of the various models;
- it will take longer to establish best practices if there are different models of mutual fund governance;

- the CSA may be reluctant to loosen existing conflict rules or to grant certain exemptive relief unless and until the CSA had sufficient experience evaluating the effectiveness of the various governance regimes;

- allowing various governance regimes may provide an incentive for mutual fund organizations to search for the least onerous choice, rather than choosing a system of mutual fund governance that best looks out for the interests of mutual fund securityholders; and

- in the event that the CSA later decide to mandate only one specific fund governance model, then the mutual fund organizations that chose another model and which would then be required to switch over to the mandated model would suffer additional switchover expenses through no fault of their own.

To summarize, I recommend:

1. Each mutual fund complex should be required to establish a governance regime that has an independent governing body.

2. In an ideal world:

   (a) Each mutual fund complex would be provided with the flexibility to determine the type of governance regime it wishes to adopt.

   (b) The CSA could monitor Canadian mutual fund complexes which have adopted different governance regimes and also monitor the mutual fund governance regimes that are recommended and implemented elsewhere in the world and, based upon the evidence garnered from such monitoring, decide at some future date whether they wish to mandate a specific governance regime.

(c) The CSA could consider whether they wish to create incentives for mutual fund complexes to adopt a specific form of governance regime by pre-conditioning certain exemptive relief (from some of the existing mutual fund conflict rules or from some requirements of National Instrument 81-102, for example) on the mutual fund complex having adopted the particular form of fund governance regime.

I believe, however, that a flexible model which permits mutual fund organizations to choose one of several types of independent governance regimes would cause difficulty in practice.

## 2. Recommendations Regarding a Specific Governance Regime

I have recommended that each mutual fund complex should be required to establish a governance regime that has some type of independent governing body. In an ideal world each mutual fund complex would be provided with the flexibility to determine the type of governance regime it wishes to adopt. After monitoring the Canadian mutual fund complexes which have adopted different governance regimes and also monitoring the mutual fund governance regimes that are recommended and implemented elsewhere in the world, the CSA could, based upon the evidence garnered from such monitoring, decide in this ideal world at some future date whether they wish to mandate a specific governance regime. In this theoretical model the CSA also could consider whether they wished to create incentives for mutual fund complexes to adopt a specific form of governance regime by preconditioning certain exemptive relief (from some of the existing mutual fund conflict rules or in connection with the requirements of

National Instrument 81-102, for example) on the mutual fund complex having adopted a particular type of fund governance regime. I also believe that, notwithstanding the flexibility offered by this theoretical model, having many different governance systems would cause difficulty in practice.

If the CSA decide that only one form of fund governance regime is to be mandated, then I recommend that each mutual fund should have a "corporate style" board (of directors, governors or trustees, as the case may be) and, in the case of mutual fund trusts that have a corporate trustee, the corporate trustee should be replaced by a board of individual trustees.

I have arrived at the recommendation that mutual funds adopt a corporate style board after considering advantages and disadvantages of the other models of independent governance regimes referred to on page 144 of this report compared to the corporate style board, which I highlight below.

### (a) A corporate trustee independent of the manager

The advantages and disadvantages of this governance model, which is utilized in the United Kingdom for unit trusts, are discussed in detail in the excerpt from the 1969 Mutual Funds Report reproduced on pages 33 to 35 of this report, but I will summarize them below.

*Advantages:*

1. An independent trustee can act as an effective check on management.

2. Reliance on an independent trustee, unlike reliance on independent directors, is consistent with the philosophy that the mutual fund is the method whereby the manager sells investment advice (rather than the mutual fund being a separate entity).

3. If successfully implemented, the use of an independent trustee would resolve the principal problems inherent in the separation of management from ownership in the context of mutual funds.

*Disadvantages:*

1. Cost of implementation. (This issue also arises, however, with independent directors of corporate style boards.)

2. The selection of a trustee from the many trust companies in Canada of all sizes and degrees of competence would have to be approved by the appropriate administrator in order to ensure the trustee's competence and to verify its independence. Such decisions would be difficult and mutual fund securityholders might suffer as a result of the use of an inappropriate trustee.

3. Competitive anomalies would result. For example, in the case of a mutual fund trust, decisions concerning the mutual fund would be scrutinized by a trust company that could be affiliated with a competing financial group.

4. An independent trustee does not have a direct stake in the success of the enterprise. (This issue, of course, also arises with independent directors of corporate style boards.)

I point out that an independent trustee, by definition, could be utilized only if the mutual fund is organized as a trust rather than as a corporation. Corporate mutual funds would require some modification to this oversight mechanism.

I also note that Australia has recently moved away from a manager and independent trustee governance model. As indicated in Part VI of this report under the heading "Mutual Fund Governance Reforms in Other Jurisdiction – 1. Australia",

Australia concluded that the dual entity structure of manager and independent trustee resulted in a displacement of responsibility and was an inefficient structure to promote compliance.

I also point out that, theoretically, an independent trustee does not have divided loyalties, so that an independent trustee can look out for the best interests of the securityholders of the mutual fund without worrying about the manager's interest. In practice, however, the trustee still may have divided loyalties if the manager has the power to appoint or terminate the trustee or determine its fees.

**(b) A corporate trustee which is not independent of the manager but which has a governance committee of the board comprised of at least a majority of individuals who are independent of the manager**

**(c) A governance committee of the board of directors of the manager, comprised of at least a majority of individuals who are independent directors**

I will discuss models (b) and (c) together as I believe they have substantially the same advantages and disadvantages.

*Advantages:*

1. The cost associated with these governance regimes may be lower than the cost of having an independent corporate style board of directors because the manager and the trustee already have a board of directors from which most of the members of the governance committees can be selected, unless the manager and trustee do not have independent persons on their boards.

2. These governance regimes would introduce some independent supervision of the mutual fund.

*Disadvantages:*

1. The governance committee will have divided loyalties as between the securityholders of the mutual fund and the stakeholders of the manager or the trustee (as the case may be). If the members of the governance committee are selected from the board of directors of the manager or trustee (as the case may be), practically it may be difficult for them to "switch hats" even if they are independent. On the other hand, the sole interest of independent directors on a corporate style board is to the securityholders of the mutual fund and, therefore, they should not have divided loyalties.

2. If the governance committee reports to the board of directors of the manager or trustee (as the case may be) and depends on the board to take actions recommended by the committee, then the committee may not have a significant amount of real power to look out for the best interests of the mutual fund securityholders, especially if the board of directors is not comprised of a majority of independent directors.

3. The pool of candidates on the existing boards to choose from in forming the governance committee may not satisfy the independence criterion or may lack the relevant experience to act on a governance committee.

4. The members of the governance committee would most likely be chosen and removed by the board of directors of the manager or trustee (as the case may be), which would not foster true independence. On a corporate style board, this power of removal could rest with the mutual fund's securityholders.

**(d) An advisory board (of directors, governors or trustees, as the case may be) of each mutual fund or of a group of mutual funds comprised of at least a majority of individuals who are independent**

*Advantages:*

1. The costs associated with having an advisory board may be less than those associated with a corporate style board of directors. This result may follow because there could be less potential for liability for advisory board members and therefore advisory board members perhaps would be compensated less than corporate style board members.

2. This governance regime introduces some independent supervision of the mutual fund.

3. This model of mutual fund governance could easily be implemented by mutual fund complexes (large and small, trust or corporation) in Canada today.

*Disadvantages:*

1. A true advisory board does not have the legal authority to enforce any of its recommendations as its very nature limits it to the role of advising. As a result, the advisory board may rely on moral suasion or other methods to influence the actions of the manager, but it has less power than independent directors of corporate style boards to look after the best interests of securityholders of mutual funds.

2. There is some uncertainty today as to the roles, responsibilities and liabilities of members of advisory boards and as to what they should be.

3. Members of an advisory board do not have a direct stake in the success of the mutual fund. (This issue, of course, also arises with independent directors of corporate style boards.)

I believe that a corporate style board, comprised of at least a majority of independent individuals whose *sole* interest is the best interests of the securityholders of the mutual fund, is a system which, if properly implemented with appropriate mandates and competent and diligent individuals, can function to look after the best interests of securityholders of the mutual fund and also benefit the mutual fund complex as a whole. As I indicated in Part III of this report entitled "History of the Mutual Fund Governance Debate in Canada", some type of corporate style board structure was recommended in the Stromberg Report,[10] the Steering Group Report,[11] the Quebec Report[12] and the Senate Committee Report.[13] A corporate style board structure is a system which, in the corporate context, is used by business corporations throughout much of the world and is required of mutual fund corporations in Canada today. A corporate style board structure also is the type of governance mechanism which the OSC has suggested since the early

1970's for closed end investment vehicles. In particular, predecessor policies to current OSC Policy 5.3 entitled "Mortgage and Real Estate Investment Trusts and Partnerships" and OSC Policy 5.4 entitled " 'Closed-End' Income Investment Trusts and Partnerships (other than Mortgage and Real Estate Investment Trusts and Partnerships)" were first published in 1972 and 1973, respectively.[14] The policies, which do not have the force of law, both indicate that the statements therein as to what should be set out in the declaration of trust or other constating documents of the issuer are merely suggestions. In the case of Policy 5.4 which is applicable to closed end mutual funds that invest in securities, the policy states in relevant part that: (i) a closed end investment trust should have at least seven trustees; (ii) the trustees should be elected and removed by the unitholders in a similar manner as directors under the *Business Corporations Act* (Ontario); (iii) the majority of the trustees should be Canadian citizens resident in Canada; (iv) the majority of the trustees should have at least five years' experience consistent with the stated investment objectives of the trust; and (v) the majority of the trustees must be independent of the adviser or its affiliates and at any meeting of the trustees the majority of the quorum must be independent.

There have been various criticisms of the corporate style board of a mutual fund in the past and it is appropriate to discuss each of these criticisms, starting with the reasons against requiring such boards set out in the 1969 Mutual Funds Report.

The Committee that authored the 1969 Mutual Funds Report supported the use of independent directors for mutual funds on a voluntary basis but the Committee did not recommend that such use be mandated.[15] The 1969 Mutual Funds Report stated that the existence of a separate board of directors for a mutual fund "may seem inconsistent with the philosophy of the mutual fund as the method whereby the management company sells investment management",[16] as compared to the philosophy of the mutual fund as a separate vehicle. The Report stated that the "inconsistency is, however, more apparent than actual in view of the wide scope of powers entrusted to the management company under the management contract and the even wider powers ordinarily exercised by it in practice".[17] The Report also stated as follows:

> "Some of them [i.e., the possible techniques to provide independent scrutiny over operations of mutual fund managers] are inconsistent with our view that the mutual fund is used by the management company to provide the service of investment management. We are not deterred by that fact from considering them on their merits; if satisfied that a technique would effectively provide continuing scrutiny and was workable, we would recommend its adoption in spite of a philosophical inconsistency."[18]

Having concluded that, notwithstanding a possible philosophical inconsistency, corporate style boards could be mandated even if one considers the mutual fund as a product rather than as a separate entity, the 1969 Mutual Funds Report then leveled certain criticisms against corporate style boards for mutual funds. The 1969 Mutual Funds Report stated as follows:

> "First, the use of independent directors in the United States has not resolved the problems inherent in the separation of management from ownership in the context of mutual funds. Second, it is clear that independent directors have not been able to deal adequately with the matters regarded by the S.E.C. as major problem areas, mentioned in the quotation in paragraph 6.38 [i.e., management compensation, allocation of brokerage and the setting of sales load levels]. Third, it seems apparent on the basis of experience both in Canada and in the United States that any effective requirement for the independence of directors would have to include a very wide and rigorous test of independence."[19]

The 1969 Mutual Funds Report also stated a final reason why it rejected the requirement of independent directors, as follows:

> "Apart from the problems shown by experience to exist, we are concerned with a question of principle inherent in the application of a requirement for the independence of directors. We question whether government should require that persons without a direct stake in the success of the operation be put in a position where they are expected to pass on the business judgment of the management company. This point of principle serves to fortify us in a decision that would in any event be dictated by the other considerations discussed above."[20]

With respect to the reasons given by the 1969 Mutual Funds Report not to recommend a corporate style board, one lawyer has written that the "actual reasons given for the Canadian Committee's decision [to reject mandating independent directors] are somewhat less compelling."[21] I concur.

In response to the 1969 Mutual Funds Report's first criticism, I believe that a form of mutual fund governance system which has independent directors as its core is at least as good as other fund governance models in resolving problems inherent in the separation of management from ownership.[22]

With respect to the 1969 Mutual Funds Report's second criticism that the independent directors have not been able to deal adequately with certain matters, in 1992 and 1999 the SEC strongly endorsed the use of independent directors in U.S. mutual funds as being the backbone of a well functioning fund governance system.[23] As recently as December 1999, for example, the Director of the SEC's Division of Investment Management stated as follows:

> "The watchdog role of independent directors is fundamental to the framework established by the 1940 Act to address conflicts of interest. Going into the 21st century, strengthening that role is one of our key roles as regulators."[24]

With respect to the 1969 Mutual Funds Report's third comment about the test of independence, I agree that the U.S. test is complex and complicated but I believe a test based upon the definition of unrelated director in the Dey Report[25] would be workable.

Finally, the Committee that authored the 1969 Mutual Funds Report was concerned with a "question of principle" as to whether government should require that persons without a direct stake in the success of a business should be placed in a position where they are expected to pass on the business judgment of the manager. It is not clear from the 1969 Mutual Funds Report whether the Committee's concern was that independent mutual fund directors would not own securities of the mutual fund or whether the independent directors would not own securities of the mutual fund manager. In any event, I suggest that a mutual fund board will not necessarily be passing on the business judgment of the fund manager. Even if the mutual fund board does pass on such business judgment, however, if thought necessary the CSA could mandate that board members must own securities of one or more of the mutual funds in the mutual fund complex or must own shares of the mutual fund manager if the fund manager is a public company. Ownership by the fund directors of mutual fund securities, or of shares of the fund manager if the fund manager is a public company, is not a requirement in the U.S.

although, as previously indicated in this report, the ICI panel which recommended best practices for U.S. fund directors in 1999 recommended that fund directors should own securities of the mutual funds on whose boards they serve.[26] In comparison, in the corporate context, directors of public companies in the U.S. and Canada are not required by law to own securities of, and thereby have a direct stake in, the public companies on whose boards they serve, although in the U.S. corporate directors frequently are paid in stock, comprised either of option grants or of direct issuances of stock.

I see no need to require mutual fund directors to own shares of the fund manager if the fund manager is a public company, as such ownership will not align the interests of the directors with the interests of the mutual fund securityholders and in fact such ownership could conflict with such interests. Although theoretically ownership by mutual fund directors of securities of the mutual funds on whose boards they serve may align the interests of the directors with the interests of the securityholders, I believe the reality is that the amount of mutual fund securities owned likely will not make a dramatic impact on the net worth of the vast majority of potential directors and, therefore, fund ownership would not be expected to materially influence the decision of a director. However, I do believe that owning securities of the mutual funds could cause the directors to identify more with mutual fund securityholders by experiencing first hand the quality of securityholder services provided by the mutual fund complex. In addition, as securityholders the directors would receive copies of all materials that are sent to mutual fund securityholders so that the directors might be prompted to consider from time to time whether these materials are adequate or whether changes could be made to the materials to provide better disclosure to mutual fund securityholders. On balance, therefore, I believe that mutual fund directors should own securities of the mutual funds on whose boards they serve.

In addition to the concerns raised in the 1969 Mutual Funds Report, there are additional issues with respect to mandating boards of mutual funds.

A major criticism relates to the expense of having a board. The expense consists of the actual cost of the directors and the cost of ancillary services for the directors.

In the United States, mutual fund directors are paid for their services by the fund while the board as a whole is responsible for setting the compensation of its members. According to a survey by Management Practice Inc.,[27] a U.S. consulting firm specializing in mutual fund governance issues, median compensation for U.S. mutual fund directors in 1998 was as follows (all figures in U.S. dollars):[28]

Median Compensation of Mutual Fund Directors in 1998

| Asset Size | Insurance Company Managed Funds Median Compensation | Bank Managed Funds Median Compensation | All Other Funds Median Compensation |
|---|---|---|---|
| $1-10 billion | $21,000 | $9,500 | $25,300 |
| Greater than $10 billion | $61,000 | $35,000 | $66,000 |

Management Practice Inc. also pointed out that while directors for larger fund groups are more highly compensated than directors of smaller fund groups, they “cost funds much less per million dollars of assets governed"[29] and further that directors of "complexes with more than $25 billion in assets are paid $1.49 per year per $1 million governed, or just over 1 cent for $10,000 (approximately the average mutual fund investment per U.S. shareholder)"[30]. Set out below is a table prepared by Management Practice Inc. upon which these statements are based (again, all figures in U.S. dollars):[31]

Total Median Compensation per Million Dollars of Assets Governed

| | | Asset Size (in Billions) | | |
|---|---|---|---|---|
| Less than $1 billion | $1-5 billion | $5-10 billion | $10-25 billion | Greater than $25 billion |
| $36.91 | $7.81 | $4.35 | $3.05 | $1.49 |

Management Practice Inc. also recently compared trends in corporate director compensation to that of mutual fund trustees in the U.S. and concluded as follows:

> "The greatest difference between corporate directors and mutual fund trustees is that the former are frequently paid in stock, either in the form of outright grants or stock options. In 1994 53% of corporate directors of the largest 200 public companies received stock awards. By 1999 98% received stock awards. Increasingly mutual fund trustees are being paid in real or deferred fund shares. The objective, just as for public corporations, is to ensure that those responsible for governance understand the motivations and frustrations of shareholders.
>
> The average compensation of a director of one of the largest 200 US public companies has risen from $78,700 in 1994 to $135,200 by 1999. Eighty one percent of this amount was paid as fixed cash or stock award retainer, and 19% as variable meeting or committee fees. MPI found in 1999 that the percent of trustees' fees paid as retainer averages 68% of total compensation.

> … The MPI 1999 Trustee Compensation Survey found that smaller fund complexes (with between $1 and $5 billion in assets) paid, on average, $17,000 while the largest complexes (with over $25 billion) paid, on average, $79,700. *Since mutual fund trustees are often drawn from the same candidate group as directors of banks, insurance companies and diversified financial companies, these amounts seem relatively small, especially since capital gains are excluded.*
>
> *While the responsibilities of a mutual fund trustee are quite different from those of a corporate director, the same pool of applicants tend to be qualified. Roughly the same set of analytical skills and attention to detail is required. By this measure independent trustees of mutual funds are comparatively inexpensive.*"[32] [emphasis added]

In addition to fees paid to mutual fund board members, there also would be other expenses of having a mutual fund board, including fees paid to consultants or professional advisers to the board and the manager's internal costs relating to servicing the board. For large fund groups, I understand that the compensation and expense figures in the aggregate are quite small as a percentage of fund complex assets. For small fund groups, however, the fees and expenses would be higher as a percentage of fund assets and may in fact result in a competitive disadvantage compared to large fund groups and other competing products.

Another criticism is that the Canadian mutual fund industry will not be able to find enough well qualified individuals to become board members. With respect to qualifications, I believe that board education programs sponsored by the manager or by a trade organization like IFIC could bring new board members a long way up the requisite learning curve. As to the number of individuals required, I recommend below that the same individuals could be board members of all funds in the mutual fund complex. It may be the case that it will be difficult to find "high profile" individuals to become board members, but I do not believe that high profile individuals would necessarily make the best mutual fund board members. Individuals who have had business experience in or outside the mutual fund area could have the appropriate background to become board members, while board education programs could teach board members what they need to know about the mutual fund business. It is key, however, that the individuals have integrity and take their roles seriously.

Another criticism that has been levied is that a mutual fund board could hinder the operations of the mutual fund complex. This criticism relates to the amount of time required, and the possible increased workload on the manager, in order to obtain various approvals from a fund board, the allegation that a fund board could micro-manage and interfere with the manager's decision-making process and the argument that it may be difficult to remove fund directors who are not seen to be working out. I believe that it is possible for a mutual fund organization to design an effective and efficient board which will not hinder the mutual fund complex carrying on business in the ordinary course. I describe the basics of such a system in my recommendations which follow.

Finally, some argue that the U.S. is the only jurisdiction which has as the underpinning of its governance regime a corporate style board of directors for their mutual funds and that Canada should not follow such a unique system. The uniqueness of the U.S. system, however, does not necessarily make it any better or worse than any other system. A board of directors style of governance does have the merit, however, of being a system which is used in the corporate context throughout much of the world and is even used in Canada for mutual fund corporations. A corporate style board also is the governance mechanism that has been suggested by the OSC for closed end investment funds in its current Policies 5.3 and 5.4 and since the early 1970's in predecessors to such policies.

Accordingly, even though there may be certain legitimate criticisms to overcome with respect to the establishment of a corporate style board for mutual funds, if the CSA conclude that they should mandate one specific form of governance regime at this time I recommend that each mutual fund should have a corporate style board (of directors, governors or trustees, as the case may be).

What should the basics of such a mutual fund board system look like? As I describe below, I believe that there should be flexibility built into the system and it should not blindly mirror the U.S. mutual fund governance regime.

I recommend that the board should consist of at least three individuals, of whom at least a majority and preferably at least two-thirds are independent of the manager. The definition of what constitutes an "independent" member should be modeled on the Dey Report's definition of "unrelated" director[33] rather than on the complex and detailed rules used in the *Investment Company Act of 1940*.[34] As stated in the ICI Best Practices Report, having at least two-thirds of the directors of every investment company board being independent "will help assure that independent directors control the voting process, particularly on matters involving potential conflicts of interest with the fund's investment adviser or other service providers".[35]

I also suggest that the independent members of the board initially would be selected and appointed by the manager. Thereafter the independent members would be appointed by the full board (and not by the manager nor by the independent members alone) or in the case of a corporate mutual fund they would be elected by the fund's shareholders as required by the fund's governing corporate statute, in either case based upon the recommendations of a nominating committee composed of at least a majority of directors who are independent of the manager. This recommendation is not entirely in accord with that of the ICI Best Practices Report, which states that independent directors should be selected and nominated by vote of a majority of the incumbent independent directors and that the fund board should delegate to the independent directors the authority to elect, or recommend that shareholders elect, the nominees if legally permitted to do so.[36] My recommendation does accord with that of the Dey Report, which stated as follows in connection with the nomination of new directors:

> "We therefore propose as our next governance guideline that the board of every corporation appoint a committee of directors composed exclusively of outside directors, a majority of whom are unrelated directors, with the responsibility for proposing new nominees to the board and for assessing directors on a ongoing basis. The actual decision as to who should be nominated should be the responsibility of the full board after considering the recommendations of the nominating committee."[37]

The salaries and expenses of the board members, including the expenses of professional advice that the board or that the independent members reasonably require to carry out their duties, must be borne either by the manager or by the funds themselves. I do not believe that there is a "right" answer as to what party should bear these expenses. In the U.S., the expenses are borne by the mutual funds. There is some merit to arguments from the Canadian mutual fund industry that if boards are mandated by the CSA, the boards are being established for the benefit of the fund securityholders and accordingly the expenses associated with the board should be borne by the securityholders. The contrary view, however, is that the expenses related to having boards of mutual funds are merely an additional cost of doing business and the manager should absorb these expenses as the price of entering into the mutual fund management business. At this time, I suggest that competition in the marketplace should determine who pays the board's fees and expenses, provided that who pays is adequately disclosed to investors. No matter who pays the fees and expenses associated with the board, however, it is important in order to ensure the independence of independent members that their salaries should be determined by the board itself (although the manager and the board jointly could set the salary levels in the first instance).

The board, similar to a board of directors of a corporation, should have the general responsibility to supervise the management of the business and affairs of the mutual fund in order that decisions affecting the mutual fund are made in the best interests of the securityholders of the mutual fund. The board should have oversight responsibilities and should not micro-manage. The board need not have a detailed list of specific duties, although certain minimum responsibilities should be established. The minimum duties could include: (i) evaluating the performance of the manager in various categories, including providing an adequate level of service to securityholders and in producing acceptable investment returns for the mutual fund, before and after expenses, in comparison to appropriate benchmarks that take into account the mutual fund's risk profile; (ii) reviewing the financial statements of the mutual fund; (iii) checking that the mutual fund is following its investment objectives; (iv) monitoring the manager's compliance with the mutual fund's compliance plan (described later in this Part VII under the heading "4. Recommendations Regarding a Compliance Plan"); and (v) making decisions on behalf of a mutual fund whenever conflict of interest issues arise between the mutual fund and any other party.

In addition to the specified minimum duties, the board should have flexibility to determine what else it should do to fulfill its broader general mandate. For example, the board may decide that it is in the best interests of mutual fund securityholders if additional information is disclosed to them that at present is not legally necessary in Canada. In this vein, the board might recommend to the manager that after-tax returns for investors at specific tax brackets and for specified time periods be disclosed to mutual fund securityholders, which is a practice that some mutual fund groups in the U.S. are voluntarily following and that the SEC is considering mandating. In addition, the board might recommend that the manager should disclose to the mutual fund securityholders whether the mutual fund's expenses which are paid to the manager or related parties are being charged at cost or whether they are being charged at a profit and, if at a profit, the amount of such profit. The board also might recommend to the manager that there is another method of disclosing expenses (i.e., as a percentage of the mutual fund's return for specified time periods) that would be relevant to mutual fund securityholders and that would make the quantum of expenses clearer to securityholders. In this regard, I quote from a 1999 booklet entitled "Strengthening Mutual Fund Governance" prepared by Management Practice, Inc., a U.S. consulting firm specializing in mutual fund governance issues:

> "In the bull market of the past six years investors have become quite insensitive to fund fee and expense levels because, as a general rule, they have done very well. Expense ratios seem comparatively low and investors understand that investment managers deserve to be highly compensated for a job well done. With this as a prevalent attitude, expense comparisons may appear reasonable even though the absolute levels are high.
>
> Part of the problem is that fund expenses are typically shown as a percent of fund assets, a very large denominator. This disclosure portrays an annual outflow of money as a fraction of a large period end balance – not unlike General Motors disclosing its operating expense as a percent of its year end total assets. Even the disclosure of how many dollars an investor will pay in expenses per $10,000 invested is not particularly meaningful to an individual investor. Shareholders would be more interested in the expense ratio if it were shown as a percent of what they earned in the same period because then they would see how much of their return has been eroded."[38]

The board also might recommend that the manager provide more information to mutual funds securityholders of the impact on them of fund expenses.

Whatever responsibilities are given to the board, however, I do not believe that the board should have the power to terminate the manager. Having the right to terminate the manager is the ultimate "big stick" but I believe it is too draconian a penalty to hold over the head of the manager, especially when investors buy into a mutual fund knowing who, and in many cases specifically because of who, is sponsoring the mutual fund. Rather than having the right to terminate the manager, I recommend that in the event that the board and the manager cannot agree on any issues, the board or the manager should report such matters to the CSA or to the securityholders of the mutual fund or, in appropriate circumstances, call a meeting of mutual fund securityholders to vote on the issues. To whom the report is made and whether a securityholder meeting will be called will be a decision of the board or the manager, as the case may be, based upon the nature of the matter in dispute. The CSA should not be required to function as a mediator in a dispute upon receipt of a report, but rather the CSA should investigate the allegations in the report and if the matters in dispute appear to violate applicable securities law or appear to be contrary to the public interest then the CSA should take appropriate action. I believe that this reporting power and the power to call a meeting of mutual fund securityholders, together with the publicity engendered if the report is made to the securityholders or the securityholder meeting is called and the threat of action by the CSA if the report is made to the CSA, should in most cases provide sufficient incentive for the board and the manager to work together and resolve any issues.

Board members should have a standard of care similar to that of directors of a business corporation, which in the case of a federal Canadian corporation are set out in subsection 122(1) of the *Canada Business Corporations Act*[39], as follows:

> "Every director and officer of a corporation in exercising his powers and discharging his duties shall
>
> (a) act honestly and in good faith with a view to the best interests of the corporation; and
>
> (b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances."[40]

This standard of care for directors under the *Canada Business Corporations Act* also is similar to that required of mutual fund managers under subsection 116(1) of the *Securities Act* (Ontario).

I believe that the board will function more effectively if one of the independent members serves as a lead member. The lead member could manage the processes of the board and could monitor the mutual fund on a regular basis. The lead member should be the key person who interacts with the fund manager on issues relating to the mutual fund. The lead member also would give the manager a contact person to speak to if and when the manager wishes to informally have discussions relating to the mutual fund.

The mutual fund complex may wish to pay the lead member more than is paid to the other independent directors. Whether or not the lead member is paid more, however, the appointment of a lead member should not detract from the legal obligations of the remaining independent members.

It is possible that directors may be involved in litigation. Such litigation may be brought by securityholders of a mutual fund, by outside third parties or by the manager itself. As stated in the ICI Best Practices Report:

> "There have been two recent cases … where fund management sought to resolve serious differences with the independent directors through litigation. Such instances have emphasized to the Advisory Group the importance of ensuring that independent directors be able to take whatever action they believe in good faith to be necessary for the protection of shareholders without concern over personal liability from litigation, particularly litigation with fund management. Such litigation can be extremely expensive and may even carry with it a potential for personal financial ruin. Consequently, the absence of adequate insurance coverage or indemnification can discourage independent directors from acting aggressively in the interests of fund shareholders and even discourage qualified individuals from serving as independent directors."[41]

Accordingly, I believe that it is important for board members to have the right to be indemnified from the assets of a mutual fund (and, if these are not sufficient, from the assets of a manager) for liabilities incurred while carrying out their duties, provided the board members have not fallen below the standard of care discussed above.[42] The board also should be authorized to purchase appropriate liability insurance for the benefit of its members, which would be paid by the mutual fund if the manager is not willing to defray the cost, but such insurance should not cover any liability resulting from not satisfying the standard of care discussed above.[43] Board members should try to obtain insurance policies that would provide coverage in situations where the directors and the manager are opposing parties in litigation. Board members also should try to obtain insurance coverage that continues to insure activities that occurred while the member was a director even if the director subsequently resigns or if the policy subsequently is terminated or modified.

In order that board members understand their duties as well as the mutual fund business, it is important that they be provided with sufficient education about the fund business in general and the mutual fund complex's operations in particular. Accordingly, I believe that it is appropriate that the manager, directly or through a trade organization such as IFIC, provide sufficient education programs to new board members and to board members on an ongoing basis. If necessary, board members could supplement these education programs by also attending outside seminars, the cost of which would be paid by the mutual fund if the manager is not willing to defray the cost.

One question that has been debated in the U.S. and Canada is whether the same individuals can sit on the boards of a number of mutual funds within the same mutual fund complex. Some commentators have suggested that each mutual fund should have its own board comprised of members different from the members of other boards of other mutual funds in the complex, others have suggested that while each mutual fund should have its own board the same people can sit as members of all the boards in a mutual fund complex (called unitary boards) or in a mutual fund family within the complex (called cluster boards), while others have suggested that if there is to be a board for mutual funds there should be but one board that covers all mutual funds in the complex or in the fund family.

Canadian mutual fund corporations have separate boards of directors for each corporation and mutual fund trusts have separate trustees for each trust. To create a simple and coherent structure, I believe it is more appropriate to have a separate board for each mutual fund rather than one board for the entire mutual fund complex or the entire fund family.

The question whether the same people can sit on the boards of all the mutual funds raises other issues. Let me quote from a 1997 article that appeared in the Journal of Financial Economics which sets out certain arguments for and against permitting individuals to sit on multiple boards of U.S. mutual funds:

> "The potential for conflicts of interest may be compounded when independent directors serve on multiple boards for a single fund sponsor. …While the fund sponsor cannot remove an independent director from a board, it can privately ask

the director not to stand for reelection, and allegedly, by such treatment, make the affected director feel 'uncomfortable'. Finally, while independent directors have regular contact with representatives of the fund sponsor through board meetings, they have little mandated contact with the fund shareholders they represent. Unlike corporate boards, who nominally meet with shareholders at annual shareholder meetings, mutual fund boards are not required to hold these meetings. Board elections are almost never publicly contested, as is frequently observed in corporate proxy contests.

By seeking to protect the current and future stream of compensation from existing and new board memberships, an independent director's interests could become more closely aligned with the fund sponsor than with the shareholders of the fund, leading to less vigilant oversight and higher fees. A clear statement of this allegation is found in the lawsuit, Olesh v. Dreyfus (CV-94-1664), filed in the Eastern District of New York, in which:

> Plaintiffs allege that by virtue of … disproportionate compensation, the interlocking directorates, and the presence of Dreyfus officers, the non-interested directors are anything but non-interested, and in fact have an ongoing business relationship with Dreyfus that overcomes their ability to judge Dreyfus' conduct independently.

In a more recent lawsuit (Strougo v. Scudder, Stevens, and Clark and the Brazil Fund (CV-95-2136), the contention was made that well-paid independent shareholders [sic] were essentially 'house directors'.

In rebuttal, others have suggested that the use of a common board of well-paid directors is beneficial for fund shareholders. The use of the same directors across multiple boards creates economies of scale and scope in oversight due to the development of specialized monitoring skills. Being gatekeepers of many funds' contracts can enhance the directors' bargaining power. By sitting on many boards, independent directors develop a stronger relationship with independent counsel. Finally, higher compensation could be the reward for better oversight skills, which could be signaled to potential customers."[44]

I would add that, should different individuals be required for the board of each mutual fund, there also are practical and logistical issues of finding sufficient numbers of qualified individuals to become members of the board and of having to hold separate board meetings of each mutual fund.

I understand that as a result of the Strougo litigation referred to above, the investment funds industry in the United States lobbied the legislatures of Massachusetts (where the majority of mutual fund trusts in the U.S. are established) and Maryland (where the majority of mutual fund corporations in the U.S. are incorporated) and legislation was enacted in those two states which now provides that mutual fund directors who are independent under the *Investment Company Act of 1940* are considered independent under state law, thereby going a long way to stop allegations similar to the plaintiff's claims in Strougo from proceeding in the future.

Chairman Levitt of the SEC also was quoted in 1999 as stating:

> "There have been questions raised in the press and in the courts about whether simply serving on multiple boards or portfolios compromises a director's independence. Recent court decisions say it doesn't. And I'm inclined to agree."[45]

For the reasons set out in the extracted article above describing why the same individuals can sit on multiple boards, as well as because of the practicality and logistics of not being able to find enough qualified individuals or having to hold separate board meetings of each mutual fund, I recommend that there should not be a restriction on the same people becoming members of the board of all of the mutual funds in a mutual fund family or a mutual fund complex.

To summarize, I recommend:

1. If the CSA decide to mandate at this time one specific form of fund governance regime, then each mutual fund should have a "corporate style" board (of directors, governors or trustees, as the case may be). Mutual fund corporations already have boards of directors and some mutual fund trusts have individual trustees who collectively constitute a board of trustees. In the case of mutual fund trusts that have a corporate trustee, the corporate trustee should be replaced by a board of individual trustees.

2. If the CSA mandate such a board structure, I believe that there should be some flexibility built into the system and it should not blindly mirror the U.S. mutual fund governance regime. I recommend that the board of a Canadian mutual fund should be constituted and should operate as follows:

   (a) The board should consist of at least three individuals of whom at least a majority and preferably at least two-thirds are independent of the manager. The definition of what constitutes an "independent" member should be modeled on the Dey Report's definition of "unrelated" director rather than on the complex and detailed rules used in the *Investment Company Act of 1940*.

   (b) There should be no restriction on the same individuals being on the boards of more than one or all of the mutual funds in a fund complex.

   (c) The independent members of the board initially would be selected and appointed by the manager. Thereafter the independent members would be appointed by the full board (and not by the manager nor by the independent members alone) or in the case of a corporate mutual fund they would be elected by the fund's shareholders as required by the fund's governing corporate statute, in either case based upon the recommendations of a nominating committee composed of at least a majority of directors who are independent of the manager.

(d) The salaries of the independent members should be determined by the board, but in the first instance they could be established by the manager and the board jointly.

(e) The salaries of the independent members, as well as any additional expenses of having a board, could be paid either by the mutual fund or by the manager.

(f) The board, as well as the independent members as a separate group, should have the power to seek whatever professional advice and incur whatever expenses they reasonably require to carry out their duties, with the cost of such advice being borne either by the mutual fund or by the manager. These expenses would be paid by the mutual fund if the manager does not agree to pay them.

(g) The board should have the general responsibility to supervise the management of the business and affairs of the mutual fund in order that decisions affecting the mutual fund are made in the best interests of the securityholders of the mutual fund. The board need not have a detailed list of specific duties, but certain minimum responsibilities should be established. The minimum duties could include: (i) evaluating the performance of the manager in various categories (including in providing an adequate level of service to securityholders and in producing acceptable investment returns for the mutual fund, before and after expenses, in comparison to appropriate benchmarks that take into account the mutual fund's risk profile); (ii) reviewing the financial statements of the mutual fund; (iii) checking that the mutual fund is following its investment objectives; (iv) monitoring the manager's compliance with the mutual fund's compliance plan; and (v) making decisions on behalf of a mutual fund whenever conflict of interest issues arise between the mutual fund and any other party. In addition to the specified minimum duties, the board should have the flexibility to determine what else it should do to fulfill its broader general mandate. The board should not have the right to terminate the manager. The board should be given sufficient power to carry out its responsibilities.

(h) Board members should have a standard of care similar to that of directors of a business corporation.

(i) Each board should have a lead member, who will be one of the independent members. The lead member should be responsible for managing the processes of the board. The lead member should monitor the mutual fund on a regular basis and should be the key person who interacts with the fund manager on issues relating to the mutual fund.

(j) Each board member should be entitled to be indemnified from the assets of the mutual fund (and, if these are not sufficient, from the assets of the manager) for liabilities incurred while carrying out his or her duties, provided the board member has not fallen below the board's standard of care.

(k) The board should be authorized to purchase appropriate liability insurance for the benefit of its members at the expense of the mutual fund, but such insurance should not cover any liability resulting from not satisfying the board's standard of care.

(l) If the board and the manager cannot agree on any issues, the board or the manager should report such matters to the CSA or to the securityholders of the mutual fund or, in appropriate circumstances, call a meeting of mutual fund securityholders to vote on the issues. To whom the report is made and whether a securityholder meeting will be called will be a decision of the board or the manager, as the case may be, based upon the nature of the matter in dispute. The CSA, however should not be required to function as a mediator.

(m) The manager, directly or through a trade organization, should provide sufficient education programs to new board members and to all board members on an ongoing basis. Board members also should have the right to supplement these education programs by attending outside seminars at the expense of the manager or, if the manager is unwilling to pay the costs, at the expense of the mutual fund.

## 3. Recommendations Regarding Registration of Mutual Fund Managers

Part III of this report entitled "History of the Mutual Fund Governance Debate in Canada" points out that the 1969 Mutual Funds Report, the 1974 Proposals,[46] the Stromberg Report, the Steering Group Report and the Quebec Report all recommended that mutual fund managers be registered. Notwithstanding these recommendations, today a mutual fund manager is not required to be registered with a securities regulatory body in Canada in order to act as the manager of a mutual fund. If, in addition to being the manager, the manager acts as a dealer in the securities of the mutual fund or as an adviser to the mutual fund, however, the manager must be registered as a mutual fund dealer or as an adviser (in Ontario, generally in the categories of investment counsel and portfolio manager), as the case may be.

The manager of a mutual fund is typically the promoter of the fund and as such is the entity which causes the fund to be established and on an on-going basis has the responsibility (together with the trustee of a mutual fund trust and the board of directors of a mutual fund corporation) for operating the mutual fund. Accordingly, the manager is a very important, and perhaps the most important, entity in ensuring the viability of the mutual fund.

In considering whether Australian mutual fund managers should be registered, the ALRC stated as follows in the ALRC Report:

> "Licensing is an effective way of imposing and monitoring the controls that the Review recommends for scheme operators. …Licensing will enable the regulator to screen out insolvent companies, those that do not have the required level of capital and those that do not have adequate compliance measures. Licensing provides a means of monitoring the operations of schemes [i.e. mutual funds] and imposing any necessary changes to the scheme's operation through licence conditions. It will also provide the ASC [Australian Securities Commission] with information about the industry which is particularly important for the purpose of surveillance. The Review recommends that all scheme operators should be licensed. It should be an offence for any person other than a court appointed temporary scheme operator or the administrator or liquidator for a scheme to operate a collective investment scheme or to issue interests in a collective investment scheme without a licence." [47]

The supervision of fund managers also has been considered by IOSCO.[48] In September 1997 the Technical Committee of IOSCO published a document entitled

"Principles for the Supervision of Operators of Collective Investment Schemes". According to the report, it was published for the following reason:

> "… CIS [collective investment scheme or schemes, as the context may require] operators increasingly engage in cross-border activities. The development of Principles for the supervision of these entities would not only facilitate the international coordination of the regulation of investment management, but would also contribute to the ultimate goal of reducing impediments to the cross border activities of CIS and their operators."[49]

The IOSCO Technical Committee indicated that mutual fund managers "may be subject to supervision by a number of different parties (such as trustees, custodians, depositories, external auditors, independent directors and compliance committees, etc.), even where the regulatory authority plays a primary role in supervision."[50] The IOSCO Technical Committee then gave the following four reasons why managers of collective investment schemes should be supervised, without specifying whether a regulatory authority or another entity should be responsible for the supervision:

> "*1. Investor Protection*
>
> The fundamental purpose of supervising an operator of a CIS is to ensure that investors' interests are protected. Supervision should seek to ensure that the assets of a CIS are managed in the best interests of its investors and in accordance with the objectives of a CIS. …
>
> An operator should also be supervised in order to confirm that the investments in a CIS are valued properly. …
>
> Investors' interests will also be protected by ensuring a CIS contains an appropriate spread of investments; …

> *2. Market Integrity*
>
> … The fact that an operator is subject to supervision may encourage investors to use CIS as vehicles for their investments. If there is no (or inadequate) supervision, there is a strong possibility that investors' interests will be adversely affected. This, in turn, will dissuade the public from investing their savings and diminish confidence in the financial markets. …
>
> *3. Integrity of Operator*
>
> An operator of a CIS will often be responsible for ensuring that all the day to day activities of operating a CIS are carried out competently. This may be a wide range of activities which includes managing the investments in accordance with the objectives of a CIS, valuation, administration, accounting, promotion and distribution. With so much responsibility resting with one entity, it is important that effective supervision is in place. …
>
> *4. Global Developments of CIS as an Investment Vehicle*
>
> CIS structures have developed rapidly and are now used globally as investment vehicles for a range of investment opportunities. For many investors a CIS is the first choice of investment vehicle which, in some respects, increases the obligations of supervisory authorities to ensure that CIS are managed properly and that these investors' interests are protected. …
>
> For the CIS industry to be able to satisfy this expectation of producing a global investment vehicle, it is important that operators are properly supervised. Failure to properly supervise may result in valuation, custodial and other types of errors which, in turn, may adversely affect large numbers of investors."[51]

Registration of a mutual fund manager should give the CSA the jurisdiction and power to inspect and monitor the operations of the mutual fund manager even if the manager is not registered as a dealer or as an adviser, thereby providing the CSA with another tool to assist them in trying to ensure that the interests of the mutual fund securityholders are being looked after adequately. The 1969 Mutual Funds Report has an interesting paragraph which is stated in a different context, but I believe the thought also is applicable in the context of the mutual fund manager:

> "8.65 *Regulatory systems often tend to weigh most heavily on the organizations for which they are least needed, namely those which are operated on an ethical basis and make it a policy to comply not only with the letter but also with the spirit of applicable rules. Other organizations, those for which the regulations are often designed, might take a more cavalier attitude towards them; reliance on a strict interpretation of the letter of the law, by contrast with conscientious adherence to its spirit, can result in completely different methods of operation. Only by effective enforcement can the disparity be rectified.* With regulations of the type proposed in this chapter and with most of the recommendations in this report, *effective enforcement can only be attained with an adequate system of inspection.* Compliance with many of the procedures proposed in this report could be confirmed only by personal inspection, and problems in other aspects of operations can be detected in that way before they develop into crises."[52] [emphasis added]

I concur with the foregoing views set out in the ALRC Report, the IOSCO Technical Committee report and the 1969 Mutual Funds Report and recommend that mutual fund managers be required to be registered with a securities regulator.

If a mutual fund manager is to be registered, the next question is what category of registration should apply. Should the mutual fund manager be registered in one of the current categories, namely either as a dealer or as an adviser, or should a separate registration category be created? The Stromberg Report recommended that "registration of managers of investment funds be a special category of registration within the adviser classification".[53] I recommend that rather than having the manager registered as an adviser or as a dealer, a separate registration category be created. I suggest this route because I believe that the manager function is different from the adviser and dealer functions and certain criteria which would be looked at by the securities regulator before permitting the mutual fund manager to be registered and on an on-going basis thereafter are different from the criteria for registering advisers or dealers. In particular, a major focus of the manager registration scheme should be to try to ensure that appropriate personnel, systems, technology and capital are available so that there will be some assurance that the manager will be able to carry out its functions and properly service the mutual fund securityholders, in compliance with all legal requirements applicable to the manager and the mutual funds.

### (a) Registration Considerations

The ALRC Report stated in relevant part as follows:

"*The main focus of the licensing process should be to reduce compliance risk.* It should do this in two ways. First, the primary factor that the ASC should consider when dealing with licence applications is the compliance measures the applicant proposes to implement. The ASC should be able to reject an application if it considers that the proposed compliance measures are not reasonably likely to detect in advance and prevent a possible breach of the law or the scheme constitution. Secondly, the directors of the applicant should be required to endorse the compliance measures that are to be imposed as license conditions and certify that, in their opinion, the measures are adequate and can be implemented.

…*The Review recommends that the law should set out a non-exhaustive list of compliance factors that the ASC must take into account in considering license applications.* They include

- arrangements for holding the scheme property, including procedures to ensure the separate identification of scheme assets
- measures for separating decision making relating to the investment and expenditure of scheme property from the implementation of those decisions

- arrangements for auditing the scheme, including the frequency of audits by internal and external auditors
- arrangements for keeping the records of the scheme.

*…The Review recommends that the directors of the operator should, before the ASC grants the licence, certify that they have examined the conditions proposed by the ASC and that they are satisfied that they are reasonably likely to detect in advance and prevent possible breaches of the law and the scheme constitution and can be put into effect by the applicant if the application is granted.* This will impress on directors the importance of the conditions of the licence and will commit the operator to the compliance measures suggested by the ASC. This approach will achieve a focus on addressing compliance risk without introducing inflexibility into the regime. It may also reduce the risk that an operators licence will be seen as some sort of guarantee by the ASC that the operator will comply with the law."[54] [emphasis added]

I concur with the foregoing recommendations in the ALRC Report.

Both the Stromberg Report and the Steering Group Report have discussed and recommended conditions of registration for mutual fund managers. As I agree with much of what these reports have stated in this regard, I will set out selected quotes from these reports.

**(b) Proficiency Requirements for Mutual Fund Managers**

The Stromberg Report recommended that

" an investment fund manager should, as a minimum, be required to have a chief executive officer, a chief financial officer, a senior administrative officer and a senior compliance officer. Each of these persons should be required to have at least five years direct experience in the investment fund/securities industry or serving the industry from outside. The chief financial officer should be required to have suitable financial and accounting training and expertise to enable such officer to fulfil the functions of such office.

> In situations where the investment fund manager is not providing investment advisory services directly to its sponsored investment funds but is retaining third parties to provide such services, the investment fund manager should be required to have on staff persons with sufficient knowledge, expertise and experience in portfolio management who will be responsible for oversight and assessment of the adequacy of the services provided by third party portfolio managers."[55]

The Steering Group Report made similar recommendations which are described in Part III of this report under the heading "5. The Steering Group Report".

I concur with the foregoing recommendations of the Steering Group and the Stromberg Report.

**(c) Capital Requirements for Mutual Fund Managers**

If a mutual fund manager is to be registered, the question arises whether there should be a minimum capital requirement applicable to the manager. In the Stromberg Report, Ms Stromberg did not question the requirement for capital, but rather recommended that

> "part of the follow-on work arising out of my Report [should] focus on establishing what the minimum amount of regulatory capital should be and how it should be calculated. Consideration might also be given to whether any reductions in these amounts is appropriate where the services required by the manager of the investment are outsourced."[56]

I believe there is merit in requiring minimum capital for managers. According to various industry participants referred to in the Stromberg Report,

> "the minimum regulatory capital for investment fund managers should be set at a high enough level to ensure that the organization is sufficiently capitalized to provide quality staff, equipment, systems and services to support the assets of fund investors."[57]

Ms Stromberg stated as follows:

> "Increased capital requirements will help ensure that the investment fund manager is able to provide and maintain quality services as fund assets grow. It will also help ensure that the investment fund manager has assets available to satisfy any legal claims."[58]

This view is echoed in a submission to the ALRC described in the ALRC Report:

> "We strongly contend that investors' interests are not well served by not having a minimum capital requirement for [operators]. A minimum capital requirement is demonstration of [an operator's] commitment to the industry, and of its substance and credentials to perform collective investment responsibility. It also offers investors an added degree of security and a sensible fiduciary discipline on [operators] who would not want to expose their capital base."[59]

The ALRC Report indicated that it "appears that an element of comfort is gained from a capital requirement, despite widespread acknowledgement that any amount chosen will be arbitrary and, for some schemes, inappropriate. A capital requirement is also seen by many as some protection against institution risk [i.e. meaning risk that the mutual fund manager will collapse]."[60]

According to the ALRC, the amount of capital necessary as a condition for mutual fund manager registration should be set at 5% of the value of the assets of all funds managed by the manager, subject to a minimum of $100,000 and a maximum of

$5,000,000.[61] The suggestion of various industry commentators set out in the Stromberg Report was that the initial minimum regulatory capital should be set at $1,000,000 and should increase as fund assets increase according to the following scale:[62]

| Fund Assets | Capital Rate | Minimum Capital |
|---|---|---|
| Less than - $100 million | - | $1,000,000 |
| $100 million - $200 million | 1.00 % | up to $2,000,000 |
| $200 million - $1 billion | 0.25 % | up to $4,000,000 |
| $1 billion - $5 billion | 0.10 % | up to $8,000,000 |
| $5 billion and over | 0.05 % | over $8,000,000 |

The Steering Group Report suggested different minimum capital requirements (see Part III of this report). I leave it to the CSA to determine what amount of capital is appropriate for a mutual fund manager.

**(d) Insurance Requirements for Mutual Fund Managers**

In addition to, and not as a substitution for, minimum capital requirements, I also recommend (as did Ms Stromberg)[63] that minimum insurance requirements for fund managers should be established. As stated by Ms Stromberg[64] and the Steering Group Report,[65] insurance should cover various risks, including property and casualty coverage, business interruption coverage and fidelity coverage. Again, I leave it to the CSA to determine the type of coverages and levels that are appropriate for a mutual fund manager. I also concur with the following recommendations from the Steering Group Report:

> "Regulators should obtain certification from the board of directors of the manager that full consideration has been given to the amount of bonding or insurance necessary to cover the insurable risks in the manager's business. Confirmation of the level of insurance coverage could also be provided to the regulators or an independent third party could be required to report on the level of insurance coverage."[66]

### (e) Board of Directors and Audit Committee of Mutual Fund Managers

If the CSA decide to mandate corporate style boards for mutual funds with at least a majority and preferably at least two-thirds of its members independent of the manager, then I see no need to require boards of directors of mutual fund managers to have a majority of independent directors. I do believe (as did Ms Stromberg)[67], however, that mutual fund managers should have an audit committee of the board, a majority of whom should be independent directors. I also believe that the members of the audit committee should have sufficient financial literacy, and in addition the chair of the audit committee should have accounting expertise, in order to be able to carry out their duties. A key function of the audit committee would be to monitor the financial integrity of the financial statements of the mutual funds and, in particular, to make sure that there are adequate procedures in place to monitor the calculations of net asset value and the types and amounts of expenses which are allocated to the mutual funds. The audit committee would report to the full board of the manager, which would be responsible for signing off on the financial statements of the mutual funds. I previously stated in Part VII under the heading "1. Recommendations Regarding Establishing an Independent Governing Body" that the independent governing body would be responsible for reviewing the mutual funds' financial statements, but I believe the primary responsibility for any errors in the financial statements should lie with the manager.

Recent announcements by the SEC have highlighted its concerns regarding the role of the audit committees of public companies which are deliberately engaging in improper earnings management.[68] Earnings management of mutual funds, however, would not be a concern of the audit committee of the manager of a mutual fund. Rather, as stated above, the key concerns of the audit committee of the mutual fund manager would be the calculation of net asset value and the verification of the types and amounts of expenses allocated to a mutual fund.

**(f) Internal and External Controls**

The Steering Group Report also described various internal controls as well as controls to monitor external service providers that the manager should have in place, stating that "[s]pecific minimum internal control procedures for transfer agency, trust accounting and fund accounting functions should be articulated."[69] Some of these controls will be dealt with at the mutual fund level in the compliance plans and reports described later in this Part VII under the heading "4. Recommendations Regarding Compliance Plan". To the extent these controls relate to the manager or other service providers, however, it is important that the manager and its audit committee monitor them.

To summarize, I recommend:

1. Each mutual fund manager should be required to be registered with the CSA. I recommend that rather than having the manager registered as an adviser or as a dealer, a separate registration category be created.

2. Conditions of registration should include minimum proficiency requirements, minimum capital requirements, minimum insurance requirements, the establishment of an audit committee and implementation of various internal controls as well as controls to monitor external service providers.

3. As part of the registration process, the board of directors of the manager should certify that it has reviewed any proposed conditions of registration and the board believes that the manager will be able to satisfy the conditions.

## 4. Recommendations Regarding a Compliance Plan

I believe it is of paramount importance that every mutual fund complex have a culture of integrity that is fostered at the most senior levels of the organization and is inculcated throughout the organization. Although a culture of integrity can be encouraged, however, it is very difficult, if not impossible, to effectively mandate such a requirement. Accordingly, whatever the form of governance regime that results from these recommendations, I believe it is important that the manager, with the input of the governance body, prepares a compliance plan for each mutual fund.

The ALRC Report stated its principal reason for a compliance plan, as follows:

> "This [i.e., compliance risk] is the most significant risk that a regulatory regime for collective investment schemes must deal with. Dealing adequately and in a cost effective way with compliance risk is the central element of the regulatory regime the Review recommends for collective investment schemes."[70]

The ALRC Report went on to make the following recommendations in connection with compliance plans:

"Incentive and responsibility

9.5 Compliance risk will be contained if scheme operators establish and give effect to compliance measures that are reasonably likely to detect in advance and prevent a potential breach of the law or the scheme's constitution. The measures the Review envisages would include rules and procedures to be followed at every stage in the management of the scheme which eliminate, as far as reasonably possible, the risk of mistake, neglect or fraud in the conduct of the scheme, and a system of checks and independent auditing to ensure that those rules and procedures are being complied with. The law should underwrite the desirability of operators implementing such measures. Simply requiring operators to have adequate compliance measures is not, however, the most effective way to achieve this. Operators must also be given an incentive to address the issue of compliance risk and must be made to take responsibility for the compliance measures under which their schemes operate. This incentive can be provided by making it a defence to most prosecutions for breaches of the law that the operator was taking all reasonable measures to prevent relevant contraventions. Encouraging scheme operators to take responsibility for compliance measures can also be achieved by requiring them to certify that the compliance measures under which they will operate are adequate."[71]

The ALRC Report continued as follows:

"9.7 The law should not specify what will constitute adequate compliance measures. Rather, the law should place the responsibility on the scheme operator to develop and implement an appropriate set of compliance measures to address a minimum number of mandatory matters. This allows for flexibility – compliance procedures will be adjusted according to the nature and features of individual schemes. This is vital to an efficient and effective regulatory framework, particularly given the wide range of schemes that fall within the definition of a collective investment scheme."[72]

As stated in the ALRC Report, a compliance plan is one way of trying to assure both the securityholders of a mutual fund and the regulator that the mutual fund is being operated in the best interests of the securityholders of the mutual fund. A compliance plan should set out the measures that the manager and the governance body will apply in managing or supervising the management of the mutual fund to ensure compliance with applicable laws and the constating documents of the mutual fund. The compliance plan will cover more matters than the compliance reports required by Part 12 of National Instrument 81-102. A compliance plan could deal with such matters as:

(i) ensuring that the assets of the mutual fund are clearly identified and held separately from other assets not belonging to the mutual fund;

(ii) setting out arrangements in relation to the committee or other persons charged with monitoring the compliance plan;

(iii) ensuring that the assets of the mutual fund are valued on a timely basis and in an appropriate manner;

(iv) ensuring that the assets of the mutual fund (including soft dollar commissions and the votes attached to the portfolio securities of the fund) are used for the best interests of the securityholders of the mutual fund;

(v) ensuring that the compliance plan is reviewed on a regular basis and, if appropriate, audited;

(vi) ensuring that adequate records of the operations of the mutual fund are kept; and

(vii) satisfying any other requirements of applicable law as to the contents and monitoring of the compliance plan.

I do not believe that the CSA should specify exactly what must be built into a compliance plan but rather should set out the goals of the compliance plan and provide guidance to the mutual fund organization as to the underlying principles for a well-functioning compliance plan. The CSA can then permit mutual fund organizations to develop compliance plans that are tailored to their specific mutual funds.

Annexed as Schedule A to this chapter is a policy statement of the Australian Securities and Investments Commission which provides guidance on how to prepare a compliance plan for an Australian mutual fund and which includes as an annex thereto illustrative guidance on what might be included in a compliance plan. One may wish to add certain items to these guidelines, such as describing the mutual fund complex's proxy voting guidelines for the portfolio securities held by the mutual funds and describing what procedures the mutual fund complex has put in place to ensure that the proxy voting guidelines are followed. I believe, however, that this policy statement is a good basis upon which the CSA could develop guidelines for the preparation of compliance plans.[73]

In an effort to make the compliance plan workable and effective, and to create an incentive for mutual fund organizations to prepare well thought out plans, I suggest that a compliance plan, if properly reviewed and monitored by the mutual fund's governance body, should create a due diligence defence for the governance body and for the manager of the mutual fund against claims alleging breaches of matters covered by the plan.

I also recommend that the compliance plan and the manager's compliance with the compliance plan should be reviewed periodically, at least by the governance body and, if the governance body or the CSA wish, by the external auditor. An annual review should be filed with the CSA as part of the annual mutual fund prospectus renewal process and should be made available for public inspection. Accordingly, even if the CSA do not have the opportunity to perform a compliance audit of a particular mutual fund organization in any given year, at least they will be able to read the filed review of the compliance plan and the manager's compliance with the plan and to raise any questions that the CSA may have. The filing of the compliance plan with the CSA should not, however, mean that the CSA have blessed the plan if litigation later arises involving the plan.

To summarize, I recommend:

1. Each mutual fund in existence today should be required to have a compliance plan, which is filed with the CSA. Adopting a compliance plan should be a condition precedent for a new mutual fund to be permitted to offer its securities to the public.

2. The compliance plan, as well as the manager's compliance with the plan, should be reviewed periodically, at least by the governance body and, if the governance body or the CSA wish, by the external auditor.

3. An annual review of the compliance plan and the manager's compliance with the plan should be filed with the CSA as part of the annual mutual fund prospectus renewal process and should be made available for public inspection.

4. The compliance plan, if properly reviewed and monitored by the mutual fund's governance body, should create a due diligence defence for the governance body and for the manager of the mutual fund against claims alleging breaches of matters covered by the plan.

## 5. Recommendations Regarding Enactment of Statutory Fiduciary Duties and a Business Judgment Rule

Section 116 of the *Securities Act* (Ontario) and equivalent provisions in other jurisdictions form the cornerstone of the existing governance regime for mutual funds in Canada. It is sometimes said that section 116 creates a statutory fiduciary duty on those responsible for managing mutual funds, but it is not clear that this is the case. Let me quote from my 1996 paper entitled "Fiduciary Duties and Conflicts of Interest in the Canadian Mutual Fund Industry":[74]

> "Traditionally, when lawyers used the term 'fiduciaries', lawyers were referring to persons that fell within recognized categories of relationships. The archetypal

fiduciary relationship was that of trustee and beneficiary. Over time, other relationships, such as those between lawyer and client and between director and corporation, were recognized as fiduciary relationships on the basis of analogies drawn to the trustee-beneficiary relationship.

Some relationships are expressly or implicitly recognized by statute to be fiduciary in nature. For example, subsection 116(1) of the Act states as follows:

> 'Every person or company responsible for the management of a mutual fund shall exercise the powers and discharge the duties of its office honestly, in good faith and in the best interests of the mutual fund, and in connection therewith shall exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.'

Notwithstanding the OSC's statement in the Conflicts Report that 'section 116 of the Act *imposes a statutory fiduciary duty* on all those responsible for the management of a fund or with the power to control the fund' (emphasis added), I would suggest that section 116 of the Act does not *expressly* create a statutory fiduciary duty but rather creates obligations (*i.e.*, to exercise powers and discharge duties 'in the best interests of the mutual fund') which a court may well recognize as *implicitly* being fiduciary in nature. In this regard, the wording of section 116 of the Act can be compared to subsection 32(1) of Ontario's *Substitute Decisions Act*, 1992, where the Ontario legislature *expressly* created a fiduciary duty:

> 'A guardian of property *is a fiduciary* whose powers and duties shall be exercised and performed diligently, with honesty and integrity and in good faith, for the incapable person's benefit.' (emphasis added)

Accordingly, the most we can say is that trustees of mutual fund trusts, directors of mutual fund corporations, managers and possibly investment advisers are implicitly fiduciaries under subsection 116 of the Act."[75]

In addition to the issue of whether a statutory fiduciary duty has been created under section 116 of the *Securities Act* (Ontario), there is another issue relating to a potential conflict between the duty (whether statutory or at common law) of the manager to the mutual fund securityholders and the manager's duty to its own stakeholders. It is possible that circumstances may arise in which these two duties conflict and, in the event of such conflict, the issue is which duty prevails.

Although it is not directly applicable, a somewhat analagous situation arises under the *Loan and Trust Corporations Act*[76] (Ontario) which indicates in section 108 as follows:

> "(2) Every director and officer of a provincial corporation in exercising his or her powers and in discharging his or her duties,
>
> (a) shall act honestly and in good faith with a view to the best interests of the corporation as a whole; and
>
> (b) shall exercise the care, diligence and skill of a reasonably prudent director or officer, as the case may be, under comparable circumstances.
>
> (3) In considering whether a particular transaction or course of action is in the best interests of the provincial corporation as a whole, a director or officer shall have *due regard to the interests of the depositors, as well as the shareholders of the corporation and, in the case of a trust corporation, shall also have due regard to the interests of the persons for whom it acts in a fiduciary capacity*." [emphasis added]

Accordingly, it is specifically stated in this statute that directors of an Ontario loan or trust corporation must have due regard to the interests of the Corporation's depositors and shareholders and, in the case of a trust corporation, the directors also must have due regard to the interests of the persons for whom the trust corporation acts in a fiduciary capacity. What again is left open under this statute, however, is how to deal with these various conflicting duties.

Australia recognized that conflicting duties could exist, although it raised this issue in the context of officers of mutual fund managers. I quote from the ALRC Report:

> "10.17 *Conflict between duties to the operator and duties to investors*. Officers of scheme operators [i.e. mutual fund managers] will continue to owe to the operator the duties set out in the Corporations Law s.232. They will, consequently, owe duties both to the operator and to investors. Where any conflict arises, the latter duty should prevail. The Review recommends that this should be expressly provided for in the Corporations Law, and that officers should be given statutory protection from claims by the operator or its shareholders arising from any loss they suffered in consequence of officers complying with their paramount duties to investors."[77]

The new legislation enacted in Australia in 1998[78] to regulate mutual funds goes further than the proposals in the ALRC Report. The new legislation refers to potential conflicting duties of the responsible entity, of officers (the definition of which in the Australian legislation includes directors) of the responsible entity and of employees of the responsible entity and, in each case, makes it clear that the duties of the responsible entity, its officers and employees to the securityholders of the mutual fund take priority over any conflicting duty which the responsible entity may have to its shareholders or which officers or employees of the responsible entity may have to the responsible entity or its shareholders. The following is an excerpt from Australia's *Managed Investments Act 1998:*

> "601FC Duties of responsible entity
>
> (1) In exercising its powers and carrying out its duties, the responsible entity of a registered scheme must:

(a) act honestly; and

(b) exercise the degree of care and diligence that a reasonable person would exercise if they were in the responsible entity's position; and

(c) *act in the best interests of the members and, if there is a conflict between the members' interests and its own interests, give priority to the members' interests*; …

(m) carry out or comply with any other duty, not inconsistent with this Law, that is conferred on the responsible entity by the scheme's constitution. …

(2) The responsible entity holds scheme property on trust for scheme members.

(3) *A duty of the responsible entity under subsection (1) or (2) overrides any conflicting duty an officer or employee of the responsible entity has under section 232*."[79] [emphasis added]

Note that section 232 referred to in the foregoing quotation sets out a standard of care and a duty of loyalty for officers of an Australian corporation. Similar language to section 601FC exists with respect to officers of the responsible entity in section 601FD and with respect to employees of the responsible entity in section 601FE.

I believe that such legislation is important because it contemplates that conflicting duties may exist and then clearly indicates that the interests of the securityholders of the mutual fund are paramount if such a conflict in fact exists, thereby relieving a person with the conflict from having to decide where his or her primary duty lies.

Accordingly, I recommend that in any jurisdiction where such duty is not already clearly legislated, laws should be enacted to create a statutory fiduciary duty of the governance body and of the manager similar to section 116 of the *Securities Act* (Ontario) in favour of the securityholders of the mutual fund. I also recommend that laws should be enacted to specify that in the event there is a conflict between the duty of the governance body, the manager or individual directors or officers to the mutual fund securityholders and any duties to other parties, the duty to the mutual fund securityholders takes precedence.

I believe it is appropriate to create additional protection for the members of the governance body who are acting in good faith in the best interests of securityholders, which in turn should make it easier to recruit qualified individuals who are willing to serve as independent members of a governance body. If additional protections were available, then potential indemnification claims against the assets of the mutual fund could be reduced, presumably the cost of liability insurance also could be reduced and perhaps it would be less likely that frivolous litigation would be brought against members of a mutual fund governance body. The type of protection I envisage is a legislated "business judgment rule" similar to the common law rules which have developed in the United States for the protection of directors, including directors of mutual funds. A layman's description of the rule is set out in this extract from the Fund Director's Guidebook published by the American Bar Association:

> "The business judgment rule, well-established in case law, protects a disinterested director who has no financial or personal interest in a transaction, contract, or matter from personal liability to the corporation and its shareholders, even though

> a corporate action approved by the director turns out to be unwise or unsuccessful. In reviewing a disinterested director's conduct, a court will not substitute its judgment (particularly in hindsight) for that of the director, provided that the director acted in good faith, was reasonably informed, and rationally believed the action taken was in the best interests of the corporation.
>
> The business judgment rule, unlike the standards of conduct encompassed in the duties of care and loyalty, is not a description of a duty or standard used to determine whether a breach of duty has occurred. It is instead an element of judicial review used in analyzing director conduct to determine whether the director should be held personally liable. If the rule applies, directors are presumed to have exercised their judgment in good faith and in the rational belief that the actions were taken in the best interests of the corporation. In such circumstances, a court will not examine the merits of a director's decision or substitute its judgment regarding the wisdom of a decision within the business judgment of directors."[80]

Accordingly, I recommend that laws be enacted to provide to the members of the governance body the benefit of a legislated business judgment rule.

To summarize, I recommend:

1. In any jurisdiction where a duty equivalent to section 116 of the *Securities Act* (Ontario) is not already clearly legislated, laws should be enacted to create a statutory fiduciary duty of the governance body and of the manager in favour of the securityholders of the mutual fund.

2. Laws should be enacted to specify that in the event there is a conflict between the duty of the governance body, the manager or individual directors or officers to the mutual fund securityholders and any duties to other parties, the duty to the mutual fund securityholders takes precedence.

3. Laws should be enacted to provide to the members of the governance body the benefit of a legislated business judgement rule.

## 6. Recommendations Regarding Uniformity of Securityholder Rights

The vast majority of mutual funds in Canada are trusts rather than corporations. I indicate under the heading "7. Recommendations Regarding Securityholder Protection" in this Part of the report that the reason for the use of trusts for public mutual funds in Canada derives from a change in the *Income Tax Act*[81] (Canada) in 1972 resulting in a tax disincentive against the use of a mutual fund corporation.

If an investor purchases shares of a mutual fund corporation, the investor's major rights are found in the share provisions creating the shares, in the business corporations statute governing the corporation and, in connection with certain fundamental changes, in Part 5 of National Instrument 81-102 (formerly Section 6 of National Policy No. 39). In the case of a mutual fund trust, the investor has rights granted by the trust document and by Part 5 of National Instrument 81-102 but there is no overriding business trust statute that ensures uniformity of rights for mutual fund securityholders. The Senate Committee Report, concurring with the Stromberg Report, recommended the enactment of legislation that would recognize a business trust structure.[82] While I do not believe it is necessary to have a complete business trust statute similar to business corporation statutes in existence in Canada today, I do believe that securityholders of all mutual funds should have uniformity of treatment on certain basic issues. These issues include the percentage of securityholders required to call meetings of securityholders, quorum requirements for securityholder meetings (whether called by the securityholders or by others) and the percentage of votes required to take action at securityholder meetings (including at adjourned meetings).

I also believe that securityholders of all mutual funds should have certain specific powers, including, if the governance body is a corporate style board, the power to call meetings of securityholders in order to remove and replace members of the board. These rights are required not just for investors in mutual fund trusts, but also for investors in mutual fund corporations because it is possible to have the voting shares of the mutual fund corporation owned by the mutual fund manager or a related entity while the shares purchased by public investors are not fully voting shares of the mutual fund corporation.

As an aside, I do not believe that it is necessary to hold annual meetings of mutual fund securityholders. Such meetings generally do not have significant turnout and there is a cost to holding such meetings. The governance body or the manager may wish to call annual securityholder meetings, however, if a cost efficient method can be developed to do so, perhaps by utilizing the internet for such meetings. In any event, each of the governance body, the manager and the mutual fund securityholders should have the power to call securityholder meetings to consider special business should the need arise.

The best way to provide the rights and powers to mutual fund securityholders which I have described would be to enact laws providing uniformity in treatment and powers, thereby ensuring that all public investors have these rights notwithstanding any contrary provisions in the trust documents, share provisions or governing corporate statute. Accordingly, I recommend that such laws be enacted. In drafting such laws, we should be able to take guidance from Canadian business corporation statutes and also from provisions in some of the business trust legislation in the United States, such as that found in the states of Delaware and Massachusetts.

To summarize, I recommend:

1. Laws should be enacted to ensure that securityholders of all mutual funds have uniformity in treatment on certain issues, including with respect to the percentage of securityholders required to call meetings of securityholders, quorum requirements for securityholder meetings and the percentage of votes required to take action at securityholder meetings.

2. Laws should be enacted to ensure that securityholders of all mutual funds have certain specific powers, including, if the governance body is a corporate style board, the power to call meetings of securityholders in order to remove and replace members of the board.

## 7. Recommendations Regarding Securityholder Protection

When investors purchase mutual fund securities, the risk which they have "bought into" is the risk that the investment performance will not be satisfactory. Investors do not, however, expect that they will lose their money because of insolvency of the mutual fund manager, fraudulent transactions or loss of limited liability as securityholders.

Recall the statements in this regard set out in the 1969 Mutual Funds Report which I have previously quoted in Part III of this report "History of the Mutual Fund Governance Debate in Canada" under the heading "1. The 1969 Mutual Funds Report":

> "6.06 If a mutual fund investor considered the risks he was prepared to accept in his investment, the only one he would consciously accept would be that his money might be partially or wholly lost as a result of a market decline or of investment decisions which turned out to be mistaken although made in good faith. He would not be prepared to accept the risk of investment decisions made in bad faith for purposes other than the good of the mutual funds; of theft; or of loss through bankruptcy or other misadventure which affects his salesman or anybody else who handled his money before it reaches the mutual fund. More precisely, he would wish to assume that such risks had been reduced to the minimum by appropriate precautions designed to prevent their occurrence. In our view, requirements to ensure that such precautions are taken form a necessary part of any regulatory scheme designed to provide protection for the mutual fund investor.
>
> 6.07 The risks referred to in the preceding paragraph result from various possibilities. Through no fault of the responsible persons, the mutual fund, management company or distribution company could encounter financial misfortune, thereby preventing fulfillment of their obligations and exposing the shareholders or unitholders to the possibility of serious loss. Alternatively, those persons with access to assets of the mutual fund might embezzle them, or the assets could be lost through theft or by fire. Finally, persons with the power to control investment decisions affecting the mutual fund might make those decisions so as to favour their own interests rather than the best interests of the mutual fund."[83]

In order to protect mutual fund securityholders against losses that could result from the insolvency or fraud of a mutual fund manager, a plan could be established to provide reimbursement to mutual fund securityholders similar to the reimbursement that would be available to clients of security dealers pursuant to the existing Canadian Investor Protection Fund. I believe it is important that some type of plan be adopted. Accordingly, I recommend that the CSA should encourage the development of a mutual fund investor compensation plan to protect securityholders against losses that could result from fraud or the insolvency of a mutual fund manager.

There is even a more basic principle that must be considered for the protection of securityholders of mutual fund trusts. Securityholders of Canadian mutual fund corporations enjoy the benefit of limited liability by virtue of common law and corporate legislation but there is no similar legislation relating to securityholders of Canadian mutual fund trusts.

Prior to 1972, the popular method for the pooling of capital by retail investors in Canada was the mutual fund corporation. In 1972, however, changes were made to the *Income Tax Act* (Canada) which resulted in a tax disincentive against the choice of a mutual fund corporation. In 1994, further changes were made to the *Income Tax Act* (Canada) to permit mutual fund corporations to convert to mutual fund trusts and thereby eliminate the tax disincentive. Accordingly, today most Canadian public mutual funds are trusts.

In the case of a beneficiary of a trust, the issue of the potential liability of the beneficiary to creditors of the trust has been the subject of a lengthy debate[84] in Canada since the early 1980's between Robert Flannigan, a law professor, and Maurice Cullity, a former law professor and practising lawyer and currently a judge of the Ontario Superior Court of Justice. The thesis propounded by Mr. Flannigan is that the "beneficiaries of a business trust could be found generally liable as principals if they were in a position to control trust assets".[85] In response, Mr. Cullity has maintained that Mr. Flannigan's thesis is not supported by Anglo-Canadian jurisprudence.

Turning to the United States, Delaware law, for example, states that to the extent provided in the governing instrument of a business trust, any person, including a beneficiary of a business trust, is entitled to direct the trustees or other persons in the management of the business trust. In addition, Delaware law limits the personal liability of beneficiaries of a Delaware business trust to the same extent as liability is limited for shareholders of private for-profit corporations organized under the laws of Delaware.[86]

I believe that most Canadian lawyers who have thought about this issue believe there is but a remote chance that liability would accrue to unitholders of a Canadian mutual fund trust if there were insufficient assets in the trust itself from which the trustee could satisfy a liability to creditors of the trust. From time to time, however, one sees risk factor sections of prospectuses for offerings of trust units that refer to such potential liability and the fact that it is remote. I suggest that no matter how remote the liability to unitholders may be, there should not even be an issue as to whether securityholders could possibly be liable for claims against the trust if there are insufficient assets in the trust from which the trustee could satisfy the liability.

Although the OSC has in the past considered unitholder liability in the context of closed end investment trusts, I do not believe the CSA have addressed the issue of liability of unitholders of a mutual fund trust. OSC Policy 5.4 (dealing with closed end income investment trusts and partnerships) indicates in Part II.N(a) that the "nature and extent of the potential personal liability of each unit holder shall be clearly disclosed" in the prospectus and that "supporting written legal opinions must be filed with the Commission". OSC Policy 5.4 also states in Part II.M.3 that with respect to "any contract entered into by the trust which would, in the ordinary course of business, be in writing, the declaration of trust must require that there be a term in each contract entered into by the issuer that the personal liability of the unit holders and trustees to third parties, including the adviser, shall be limited to their interests in the trust assets". Section 6.2 of Companion Policy 81-102CP to recently enacted National Instrument 81-102 refers to mutual funds structured as corporations and as limited partnerships and indicates that there is an issue about the loss of limited liability if limited partners participate in the management and control of the partnership. There is no reference to any potential liability of unitholders of mutual fund trusts, perhaps because the CSA also believe that in Canada today the possibility of such liability is remote. Subsection 6.2(1) of the Companion Policy, however, does state as follows:

> "Mutual funds generally are structured in a manner that ensures that investors are not exposed to the risk of loss of an amount more than their original investment. This is a very important and essential attribute of mutual funds."

Accordingly, in order to backstop this "very important and essential attribute of mutual funds" that are structured as trusts and which are by far the prevalent form of mutual funds in Canada today, I recommend that legislation be enacted to ensure that unitholders of Canadian mutual fund trusts have limited liability similar to shareholders of Canadian mutual fund corporations.

To summarize, I recommend:

1. The CSA should encourage the development of a mutual fund investor compensation plan to protect securityholders against any losses that could result from the insolvency or fraud of a mutual fund manager.

2. Laws should be enacted to ensure that unitholders of mutual fund trusts have limited liability similar to shareholders of mutual fund corporations.

## 8. Recommendations Regarding Role of the CSA

As an ancillary measure to the establishment of independent governance bodies for mutual funds, the registration of mutual fund managers and the other recommendations in this report, I believe it is important to have a securities regulator that is able to be involved, and when necessary publicly seen to be involved, in ensuring that decisions in a mutual fund complex are made in the best interests of the securityholders of the mutual fund.

In order to achieve this result, I have previously recommended that a compliance plan be required to be prepared and filed with the CSA for each mutual fund as part of the annual mutual fund prospectus renewal process. Accordingly, the CSA would have the opportunity to review the initial compliance plan and any amendments to it, as well as have the opportunity to look at the annual reviews of such compliance plan made by the governance body and possibly by the external auditor.

In addition to this role, however, the CSA must have sufficient powers to inspect and discipline all actors in the mutual fund complex, including the mutual fund, its manager and, if applicable, its trustee. In Ontario, for example, the OSC can rely on its power under section 20 of the *Securities Act* (Ontario) to examine books and records that are required to be kept by market participants (defined in subsection 1(1) of the statute to include "a manager or custodian of assets, shares or units of a mutual fund", but this definition may not be broad enough to include a trustee which is not the manager or custodian) and its various disciplinary powers under the statute. If current powers in any jurisdiction are not sufficient, however, I recommend that laws should be enacted to provide such powers to the CSA.

I also believe that it is important for the mutual fund industry to know that in the event there are cases of abuse the CSA will take appropriate action. I believe that the possible adverse consequences to a mutual fund organization that can arise from public disclosure of abuses can be an excellent deterrent. As it has often been said, sunlight is the best of disinfectants and electric light the best policeman. Accordingly, I recommend that the CSA should effect inspections of mutual fund complexes on a regular basis and publicly report the results of problems encountered.

Depending upon the type of governance regime which is enacted, it also may be very important for the CSA to review any matters brought to their attention by the governance body or by the manager of the mutual fund and to take appropriate action where necessary. In this regard, the SEC has been criticized in the past for not taking action to support the independent directors of U.S. investment companies when these directors have brought matters to the SEC's attention. In October 1999 the SEC responded to these allegations as follows:

> "Over the past few years, the Commission has been criticized for not taking certain actions in connection with disputes between independent fund directors and fund management. Specifically, some persons have suggested that the Commission should have taken action against certain investment advisers based on allegations made by funds' independent directors that the advisers had violated the federal securities laws. …
>
> We also believe that it would be helpful to clarify the Commission's role and procedures in connection with disputes between independent fund directors and fund management. The Commission's role, as a general matter, is to interpret, administer and enforce the federal securities laws for the protection of investors. Accordingly, the Commission's role in connection with internal fund disputes generally is to provide guidance regarding the requirements of the federal securities laws, investigate possible violations of these laws, and institute enforcement actions in appropriate circumstances when the Commission believes that these laws have been violated. While there may be instances in which the Commission, in fulfilling this role, may indirectly assist one party in a dispute, the Commission generally will not mediate private disputes, side with one party over another, or seek to effect a particular outcome. Rather, the Commission will assist the parties to understand the requirements of the federal securities laws, evaluate all allegations of violations of those laws, and take appropriate action for the protection of investors. …
>
> As described above, the Commission and the staff are committed to carefully reviewing all allegations of violations of the federal securities laws, and taking appropriate action when a violation has occurred. The Commission's and the staff's actions, and any decisions not to act, will be based on all facts that are available to us, and will not necessarily be explained to the public. These positions are necessary to ensure the fairness and integrity of the examination and investigative process. The Commission and the staff also are dedicated to enhancing the fairness and integrity of the fund governance process, and will consider instituting enforcement proceedings or taking other public positions if they will further this goal."[87]

I recommend that the CSA should make it clear that they are ready, willing and able to listen to complaints from the independent governance body or from the manager relating to violations of applicable securities laws or matters that are contrary to the public interest and to commence investigations or take whatever other actions may be appropriate in the circumstances. As I have previously indicated, however, the CSA should not be functioning as a mediator in a dispute between the governance body and the manager.

To summarize, I recommend:

1. The CSA should have sufficient powers to inspect and discipline all actors in the mutual fund complex, including the mutual fund, its manager and, if applicable, its trustee. If current powers in any jurisdiction are not sufficient, laws should be enacted to provide such powers to the CSA.

2. The CSA should effect inspections of mutual fund complexes on a regular basis and publicly report the results of problems encountered.

3. The CSA should make it clear that they are ready, willing and able to listen to complaints from the independent governance body or from the manager relating to violations of applicable securities laws or matters that are contrary to the public interest and to commence investigations or take whatever other actions may be appropriate in the circumstances.

## 9. Recommendations Regarding Disclosure

One of the primary underpinnings of securities laws in Canada is the requirement of disclosure. In the mutual fund context, disclosure refers to setting out in the prospectus and annual information form all material facts relating to the mutual fund securities being offered for sale and also providing additional information in the financial statements and other periodic reports to securityholders of the mutual funds. Although disclosure is not a panacea for all problems, especially in light of the fact that many securityholders do not read the disclosed information on a timely basis or at all or even if securityholders read the information they may not understand it, I do believe that sunlight is the best of disinfectants and electric light the best policeman and, accordingly, that appropriate disclosure still is advantageous for securityholders.

The question is whether, in the context of mutual fund governance, there is any information that could be beneficial to unitholders and which currently is not required to be disclosed. I believe the answer is yes.

### (a) Approach to Fund Governance

Item 12 of Form 81-101F2 under National Instrument 81-101 sets out what must be stated in relation to fund governance in an annual information form. Section 1 of Item 12 states as follows:

> "(1) Provide detailed information concerning the governance of the mutual fund, including information concerning

(a) the body or group that has responsibility for fund governance, the extent to which its members are independent of the manager of the mutual fund and the names and municipalities of residence of each member of that body or group; and

(b) descriptions of the policies, practices or guidelines of the mutual fund or the manager relating to business practices, sales practices, risk management controls and internal conflicts of interest, and if the mutual fund or the manager have no such policies, practices or guidelines, a statement to that effect."

In the corporate context, the Dey Report also supported the disclosure of governance practices of public companies. In relevant part, the Dey Report stated as follows:

> "We recommend that every company incorporated in Canada or a province of Canada whose shares are traded publicly in Canada be required to disclose on an annual basis its approach to corporate governance. The disclosure – a 'Statement of Corporate Governance Practices' – should be made in the corporation's annual report or information circular. When we say disclose its approach to corporate governance, we mean a description of the corporation's system of corporate governance with reference to the guidelines that we have proposed in this Report and, where the company's system is different from the guidelines, an explanation of the differences."[88]

This suggestion in the Dey Report has been adopted by the Toronto Stock Exchange and is now set out in Section 473 of the Toronto Stock Exchange Company Manual.

I concur with this approach. I would recommend, however, that Item 12 of Form 81-101F2 be amended so that the required disclosure also would set out the mutual fund complex's approach to fund governance, including:

(i) the basis upon which the mutual fund organization has concluded that the independent governance body is independent; and

(ii) a description of each mutual fund's compliance plan.

The CSA also should consider whether the fund governance disclosure should be moved from the annual information form to the simplified prospectus or made available to investors on some other basis, such as on the fund complex's internet website.

**(b) Voting Guidelines With Respect to Portfolio Securities**

The manner in which the portfolio securities owned by mutual funds are voted at shareholder meetings of the portfolio companies is not required to be disclosed to mutual fund securityholders nor to the portfolio companies whose securities are owned by the mutual funds. The right to vote the securities of the portfolio companies is an asset of the mutual fund and in many cases can be valuable in determining the fundamental direction of the portfolio company, whether in connection with the annual election of directors or in connection with any special item of business which may be voted upon at a special shareholders meeting. As the right to vote is an asset of the mutual fund, the fiduciary duty of the manager or adviser to the mutual fund is to vote (or refrain from voting) the portfolio securities in the best interests of the securityholders of the mutual fund.

The Pension Investment Association of Canada ("PIAC") has published the PIAC Corporate Governance Standards, which state in relevant part as follows:

> "Stock ownership rights, which include proxy votes and participation in corporate bankruptcy proceedings and shareholder litigation, are a financial asset. They

> must be managed with the same care, skill, prudence and diligence as any other financial asset. Such rights must be exercised by fiduciaries for the exclusive benefit of pension plan beneficiaries in such a way as to protect and enhance long-term shareholder value.
>
> Managing stock ownership rights and the proxy vote includes questions about preserving the full integrity – and value – of the ownership characteristics of common stock. For example, the value of the vote may be diminished by a classified board or by dual class capitalization and the right to transfer the stock to a willing buyer at a mutually agreeable price may be abrogated by the adoption of a 'poison pill'.
>
> …Effective shareholders will keep themselves informed about corporate governance issues, not shrink from an activist role, exercise, where possible, their right to make shareholder proposals in support of these Standards and manage their proxy votes in order to protect stock ownership rights from erosion."[89]

In addition, guidelines of many large pension funds explain how such pension funds vote the securities in their portfolios. In this regard, the Senate Committee Report stated as follows:

> "OMERS told the Committee that its fiduciary duties require it to vote its proxies. Voting rights are the property of the pension fund and have a recognized market value. OMERS is asked to vote on more than 1,200 proxies each year, most of which are routine. It uses its own internal researchers and a number of services to review proxies and alert it to major changes proposed by companies.
>
> Not all institutional investors, however, assign the same importance to proxy voting. A survey of PIAC members completed in 1997, revealed that though a significant number of respondents were notified of important corporate issues, 71% of them did not provide specific instructions to external managers on proxy issues. Of the respondents, 26% analyzed proxy material internally while 50% believed such material was analyzed by external managers.
>
> Institutional Investors such as OMERS, the OTPPB, and the Ontario Public Service Employees Union Pension Trust have developed their own proxy voting guidelines. These guidelines often contain general statements of policy on various aspects of corporate governance and specific recommendations on

numerous issues. The PIAC survey revealed that 66% of respondents have a proxy voting policy. While allowing flexibility to judge each situation on an individual basis, the OMERS guidelines made a number of specific recommendations for voting. Under most circumstances, OMERS will direct its votes to be cast in the following manner:

- against stock option clauses that do not meet the criteria set forth in the guidelines;
- against 'golden parachutes';
- against most 'poison pills';
- against leveraged buyout proposals if OMERS believes that management or the board of directors have not adequately pursued shareholders' interests;
- against unequal or subordinate voting shares;
- against 'greenmail' transactions;
- against unlimited or excessive share issues, including unlimited 'blank cheque' preferred shares."[90]

SEC Commissioner Paul Carey recently discussed how U.S. fund advisers should exercise their voting powers. In a speech in December 1999, he stated as follows:

"…Some fund advisers approach these corporate governance issues simply by voting proxies according to the recommendations of proxy consultants. Many other fund advisers 'vote with their feet' by selling if they are dissatisfied with company management, rather than trying to work with company management to increase shareholder value.

Again, an obvious question is called to mind: Should fund advisers do more?

Sometimes, fund advisers may not do more because they have concluded that doing more is <u>not</u> in the best interest of the fund. Clearly, fund advisers must engage in cost/benefit analysis, and weigh the costs of possible courses of action against the potential benefits to the fund. In some cases, the costs of engaging company management on an issue may outweigh the potential benefits that may accrue to the fund. Fund advisers should not expend resources if they have no

> reasonable expectation that doing so will provide a net benefit to the fund. For example, if a fund holds only a small position in a company, a decision to not engage management in discussions, or to switch rather than fight, may be appropriate – particularly if the issue involved would not significantly affect the value of the fund's holdings.
>
> *Unfortunately, sometimes, fund advisers may not do more, because, to do more, might conflict with the interests of the adviser. A fund adviser could have an economic interest to vote the fund's shares to please company management, even if such a vote might not be in the best interests of the fund.* This could be because a fund adviser might manage – or hope to manage – the retirement plan of a company whose stock is owned by the fund. If the fund adviser wants the pension business of XYZ Company, or it wants to continue to manage XYZ's pension business, it might think twice before voting against the recommendation of XYZ's management – even if voting against the recommendation could increase the value of the funds' holdings. *Clearly, this result is contrary to a fund adviser's fiduciary duty to the fund and its shareholders. …*
>
> *In closing, fund governance issues continue to be at the forefront of our concern. How investment advisers exercise fund voting power is an important issue that fund boards and advisers should consider. I ask that you think about what you can do to enhance funds' voting power in order to maximize shareholder value, and to fairly recognize and address conflict of interest situations.* Consider whether it makes sense to have procedures in place to address these issues. Know what process is taking place now, and decide if the process is in the best interest of the fund. I also ask that you consider whether disclosing fund voting practices or policies would be useful information for your shareholders."[91] [emphasis added]

Accordingly, I recommend that at a minimum each mutual fund complex should be required to disclose in the simplified prospectus the guidelines that the manager or the portfolio adviser follows in determining whether and how to vote portfolio securities at shareholders' meetings of companies held in the portfolios of the mutual funds. The CSA should consider whether such disclosure also should be made in some other manner, such as on the fund complex's internet website.

To summarize, I recommend:

1. Each mutual fund complex should be required to disclose the mutual fund complex's approach to fund governance, including: (i) the basis upon which the mutual fund organization has concluded that the independent governance body is independent; and (ii) a description of each mutual fund's compliance plan. The CSA should consider whether governance disclosure should be moved from the annual information form to the simplified prospectus or made available to investors on some other basis, such as on the fund complex's internet website.

2. Each mutual fund complex should be required to disclose in the simplified prospectus the guidelines that the manager or the portfolio adviser follows in determining whether and how to vote portfolio securities at shareholders' meetings of companies held in the portfolios of the mutual funds. The CSA should consider whether such disclosure also should be made in some other manner, such as on the fund complex's internet website.

## 10. Recommendations Regarding Best Practice Guidelines

Instituting a governance regime will be a new step for Canadian mutual funds. In order to assist the governance body, in whatever form it may exist, to carry out its responsibilities in an acceptable manner, it would be appropriate for best practice guidelines relating to mutual fund governance to be developed and reviewed from time to time. Such guidelines have been prepared in the U.S. by the ICI, the trade association for mutual fund managers. In June of 1999, for example, the ICI Best Practices Report was published and in it the Advisory Group recommended 15 best practices designed to enhance the role of mutual fund directors (previously referred to in Part VI of this report "Mutual Fund Governance Reforms in Other Jurisdictions" under the heading "2. United States").[92]

In developing and enunciating these best practice guidelines, the CSA should remind the mutual fund industry that adherence to such guidelines does not absolve industry members from their obligations to comply with applicable laws, including applicable securities law and applicable common law relating to fiduciary obligations.

To summarize, I recommend that best practice guidelines relating to Canadian mutual fund governance should be developed from time to time by the CSA in conjunction with the mutual fund industry.

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[1] *Report of the Canadian Committee on Mutual Funds and Investment Contracts – Provincial and Federal Study, 1969* (Ottawa: Queen's Printer, 1969) [hereinafter *1969 Mutual Funds Report*].

[2] The description of the "to-ing and fro-ing" behind the implementation of the recent Australian fund governance legislation described in Part VI of this report under the heading "Mutual Fund Governance Reforms in Other Jurisdictions – 1. Australia – History" shows that mutual fund governance can raise legal, political and other policy issues that do not have clearcut answers.

[3] I.M. Millstein, "Red Herring over Independent Boards" *The New York Times* (6 April 1997) 10 Money & Business. An excerpt from this article appears in Part I of this report.

[4] *Ibid*.

[5] I am told, however, that some U.S. mutual fund groups which have operations outside of the U.S. have voluntarily adopted a U.S. style mutual fund board of directors system in some jurisdictions outside the U.S.

[6] H. Kaback, "Martin Lipton: For the Defense" (summer 1999) Directors & Boards at [10].

[7] *1969 Mutual Funds Report*, *supra* note 1 at 161.

[8] "Role of Independent Directors of Investment Companies", Release Nos. 33-7754; 34-42007; IC-24082; File No. S7-23-99, (15 October 1999). This document can be found on the SEC website at www.sec.gov/rules/proposed/34-42007/htm.

[9] *Ibid*.

[10] *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Investment Funds in Canada*, Prepared by G. Stromberg for the Canadian Securities Administrators (Ontario Securities Commission, January 1995) [hereinafter *Stromberg Report*].

[11] Investment Funds Steering Group, *The Stromberg Report: An Industry Perspective*, Prepared for the Canadian Securities Administrators (Toronto: Queen's Printer, November 1996) [hereinafter *Steering Group Report*].

[12] Consultative Committee on the Regulation of Mutual Funds, *La Modernization du Cadre Normatif dans le Contexte Québécois*, Prepared for the Quebec Securities Commission (January 1997).

[13] *Report of the Standing Senate Committee on Banking, Trade and Commerce: The Governance Practices of Institutional Investors* (November 1998) (Chair: M. Kirby) [hereinafter *Senate Committee Report*].

[14] Former Policy 3-25, first published (1972) O.S.C.B. 181, was the predecessor to current Policy 5.3 and former Policy 3-26, first published (1973) O.S.C.B. 153, was the predecessor to current Policy 5.4.

[15] *1969 Mutual Funds Report*, *supra* note 1 at 161. I describe the reasons that the authors of the *1969 Mutual Funds Report* gave for not mandating mutual fund directors in Part III of this report under the heading "History of the Mutual Fund Governance Debate in Canada: 1. The 1969 Mutual Fund Report: (b) Independent Directors".

[16] *Ibid*.

[17] *Ibid*.

[18] *Ibid* at 152.

[19] *Ibid* at 164-165.

[20] *Ibid* at 165.

[21] W. J. Braithwaite, "Who is Best Suited to Introduce Corporate Governance Reform and Mutual Fund Governance Reform?" in *Securities Regulation: Issues and Perspectives: Papers Presented at the Queen's Annual Business Law Symposium, 1994* (Toronto: Thomson Canada Limited, 1995) 277 at 310.

[22] There are various ways to align the interests of management and ownership in a mutual fund complex. The "*mutual* mutual fund model" adopted by the Vanguard Group in the United States (described in Part V of this report under the heading "Survey of Mutual Fund Governance Structures – 5. An Innovative Model") is perhaps the purest model of aligning the interests of the mutual fund securityholders with the interests of the mutual fund manager. A performance fee which is permitted by section 7.1 of National Instrument 81-102 also could be structured to align these interests.

[23] Division of Investment Management, United States Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (Washington, D.C.: U.S. Government Printing Office, May 1992) at 266; U.S. Securities and Exchange Commission, *Roundtable on the Role of Independent Investment Company Directors* (Washington, D.C., 23-24 February 1999) found on the SEC website at www.sec.gov/offices/invmgmt/roundtab.htm.

[24] P.F. Roye, "Mutual Funds – A Century of Success; Challenges and Opportunities for the Future" (Remarks before the Securities Law Developments Conference ICI Education Foundation, 9 December 1999) available on the SEC website at www.sec.gov/news/speeches/spch336.htm.

[25] *Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada: "Where Were the Directors": Guidelines for Improved Corporate Governance in Canada* (December 1994)(Chair: P. Dey, Q.C.) at 24 [hereinafter *Dey Report*].

[26] *Report of the Advisory Group on Best Practices for Fund Directors: Enhancing a Culture of Independence and Effectiveness* (Investment Company Institute, 24 June 1999) (Chair J. Brennan) at 17 [hereinafter *ICI Best Practices Report*].

[27] "1999 Mutual Fund Directors' Compensation Survey finds Bank Directors' Paid Significantly Less" (April 1999) Management Practice Bulletin.

[28] *Ibid.* at 1.

[29] *Ibid.* at 2.

[30] *Ibid*.

[31] *Ibid*.

[32] "Assessing the Relevance of Trends in Corporate Director Compensation to Mutual Fund Trustees" (February 2000) Management Practice Bulletin.

[33] *Dey Report*, *supra* note 25 at 24: "We define an unrelated director as 'a director who is independent of management and is free from any interest and any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director's ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding. A related director is a director who is not an unrelated director.' "

[34] 54 Stat. 789 (15 U.S.C. 80a-1 et. seq.), s.2(a)(19).

[35] *ICI Best Practices Report*, *supra* note 26 at 10.

[36] *Ibid.* at 14-16.

[37] *Dey Report*, *supra* note 25 at 28.

[38] "Strengthening Mutual Fund Governance: A Research Report and Discussion Paper" (New York: Management Practice Inc., 1999) at 7-8.

[39] R.S.C. 1985, c.C-44.

[40] In the case of a mutual fund board, the reference to "corporation" in the first line of the quotation would be changed to "mutual fund" while the reference to "corporation" in clause (a) of the quotation should be changed to "securityholders of the mutual fund".

[41] *ICI Best Practices Report*, *supra* note 26 at 26.

[42] Subsection 4.4(3) of National Instrument 81-102 permits a mutual fund to indemnify persons or companies providing services to it against legal fees, judgments and settlement amounts provided certain criteria are satisfied, but the provisions are permissive and not mandatory. It also is not clear how the exception in subsection 4.4(5) for directors of mutual funds will work, although the CSA's stated intention (set out in (1999) 22 O.S.C.B. (Supp.) at 88) was to have the liability and indemnification of directors of mutual funds addressed by corporate law.

[43] Subsection 4.4(4) of National Instrument 81-102 permits a mutual fund to pay certain costs of liability insurance for a person or company provided the person or company is entitled to be indemnified under subsection 4.4(3). Again, however, the provision is permissive and not mandatory and it is not clear how the exception in subsection 4.4(5) for directors of mutual funds will work.

[44] P. Tufano & M. Sevick, "Board Structure and Fee-Setting in the U.S. Mutual Fund Industry" (1997) 46 J. Fin. Economics 321 at 329-330.

[45] A. Levitt, "Keeping Faith with the Shareholder Interest: Strengthening the Role of Independent Directors of Mutual Funds" (Remarks to the Mutual Funds and Investment Management Conference, 22 March 1999) available on the SEC website at www.sec.gov.news/speeches/spch 259.htm.

[46] Consumer and Corporate Affairs, *Proposals for a Canada Mutual Funds Law*, Vols. I & II by J.C. Baillie & W.M.H. Grover (Ottawa: Information Canada, 1974).

[47] Australia, Law Reform Commission and Companies and Securities Advisory Committee, *Report No. 65: Collective Investments: Other People's Money* (1993) Vol. 1 at 103 [hereinafter *ALRC Report*].

[48] In addition to the September 1997 Report of the Technical Committee of IOSCO entitled *Principles for the Supervision of Operators of Collective Investment Schemes* dealing with supervision of CIS operators [hereinafter *1997 IOSCO Report*], the IOSCO Technical Committee also published a report in 1994 which discussed, among other things, supervision of CIS operators and eligibility requirements in order to act as a CIS operator. This 1994 report is entitled *Report on Investment Management – Principles for the Regulation of Collective Management Schemes and Explanatory Memorandum* (October 1994) and is available in full on the IOSCO website at www.iosco.org. Excerpts from the 1994 IOSCO report are set out in Part VI of this report under the heading "3. IOSCO".

[49] *1997 IOSCO Report*, *supra* note 48 at 3.

[50] *Ibid.* at 1.

[51] *Ibid.* at 4-5.

[52] *1969 Mutual Funds Report*, *supra* note 1 at 264-265.

[53] *Stromberg Report, supra* note 10 at 89.

[54] *ALRC Report*, *supra* note 47 at 104-107.

[55] *Stromberg Report, supra* note 10 at 97.

[56] *Ibid.* at 91-92.

[57] *Ibid.* at 90-91.

[58] *Ibid.* at 91.

[59] *ALRC Report*, *supra* note 47 at 100.

[60] *Ibid*.

[61] *Ibid.* at 101.

[62] *Stromberg Report, supra* note 10 at 91.

[63] *Ibid.* at 93.

[64] *Ibid*.

[65] *Steering Group Report*, *supra* note 11 at 28-29.

[66] *Ibid*. at 29.

[67] *Stromberg Report, supra* note 10 at 98.

[68] See Fact Sheet: "SEC Proposals Implementing Blue Ribbon Committee's Recommendations Regarding Audit Committee Effectiveness" (6 October 1999) at www.sec.gov/news/press/99-127.txt, and Fact Sheet: "Rules for Enhancing Audit Committee Effectiveness" (15 December 1999) at www.sec.gov/news/extra/audeffaq.htm.

[69] *Steering Group Report*, *supra* note 11 at 29.

70 *ALRC Report*, *supra* note 47 at 81.

71 *Ibid.* at 82.

72 *Ibid.* at 83.

73 The Canadian Institute of Chartered Accountants has prepared a research report entitled "Assessing Risks & Controls of Investment Funds – Guidance for Directors, Auditors and Regulators" (Toronto: 2000) to provide guidance on auditing and related matters that are pertinent to the investment funds industry. This report also should be useful in assisting in the preparation and review of compliance plans.

74 S.I. Erlichman, "Fiduciary Duties and Conflicts of Interest in the Canadian Mutual Fund Industry" in *Fiduciary Obligations: Implications for Financial Institutions and Funds* (Presentation to the Osgoode Hall Law School of York University Professional Development Programme, 2 October 1996).

75 *Ibid* at 11-12.

76 R.S.O. 1990, c.L.25.

77 *ALRC Report*, *supra* note 47 at 96.

78 *Managed Investments Act 1998*, No. 62, 1998.

79 *Ibid*. at Sch. 1, s.1, pt. 5C.2, Div. 1, 601FC.

80 Task Force on *Fund Director's Guidebook*, Federal Regulation of Securities Committee, *Fund Director's Guidebook* (Section of Business Law, American Bar Association, 1996) (Co-chairs: J.W. Gleason & T.R. Smith, Jr.) at 11.

81 R.S.C. 1985 (5th Supp.), C.1.

82 *Senate Committee Report*, *supra* note 13 at 3.

83 *1969 Mutual Funds Report*, *supra* note 1 at 150-151.

84 R.D. Flannigan, "Beneficiary Liability in Business Trusts" (1982-84) 6 E.T.Q. 278; M.C. Cullity, "Liability of Beneficiaries - A Rejoinder" (1985-86) 7 E.T.Q. 35; R.D. Flannigan, "The Control Test of Principal Status Applied to Business Trusts" (1986-88) 8 E.T.Q. 37; M.C. Cullity, "Liability of Beneficiaries - A Further Rejoinder to Mr. Flannigan" (1986) 8 E.T.Q. 130; R.D. Flannigan, "Trust or Agency: Beneficiary Liability and the Wise Old Birds" in S. Goldstein, ed., *Equity and Contemporary Legal Developments* (Jerusalem: Hebrew University, 1992) 275 [hereinafter "Wise Old Birds"]; M.C. Cullity, "Personal Liability of Trustees and Rights of Indemnification" (1996) 16 E.T.Q. 115.

85 "Wise Old Birds", *supra* note 84 at 275.

86 Del. Code Ann. tit.12 s.3803(a) and s.3806(a).

87 SEC Interpretation, "Matters Concerning Independent Directors of Investment Companies", Release No. IC-24083 (14 October 1999). This document can be found at the SEC website at www.sec.gov/rules/concept/ic-24083.htm.

88 *Dey Report*, *supra* note 25 at 51.

89 Pension Investment Association of Canada, *PIAC Corporate Governance Standards* (June 1998 Update) at 6.

90 *Senate Committee Report*, *supra* note 13 at 62-63.

91 P.R. Carey, Remarks (Investment Company Institute Procedures Conference, 9 December 1999).

92 *ICI Best Practices Report*, *supra* note 26.

# SCHEDULE A

## AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION POLICY STATEMENT RELATING TO MUTUAL FUND COMPLIANCE PLANS

**[PS 132]**

**Managed investments: Compliance plans**

Related instruments [CO 98/50]

Chapter 5C — Managed investment schemes

*Issued 3/8/1998*

*Updated 4/11/1998*

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**What this policy statement is about**

*In order to gain a full understanding of our policy in this area you should read all the parts of this policy statement, including the Underlying Principles and the Explanations.*

**[PS 132.1]** This policy statement gives you guidance on how to prepare a compliance plan for a managed investment scheme. It includes, as an Annexure, illustrative guidance on what might be included in a compliance plan.

*see [PS 132.2]—[PS 132.22]*

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**Contents**

## How to prepare a compliance plan

### Our policy

***Preparing a compliance plan***

**[PS 132.2]** In preparing a compliance plan, you should:

(a) undertake a structured and systematic process which considers the responsible entity's obligations under the Law and the scheme constitution;

(b) identify the risks of non-compliance; and

(c) establish measures designed to meet these risks.

***No ASIC checklist***

**[PS 132.3]** We do not have a checklist of what must be built into a compliance plan.

***Level of detail***

**[PS 132.4]** A compliance plan should describe the structures, systems and processes without detailing every aspect or step in the process. The measures should be set out with enough certainty to allow us and the auditor of the compliance plan to assess whether the responsible entity has complied with the compliance plan.

***Incorporating parts of other plans***

**[PS 132.5]** We have modified the Law so that a compliance plan can incorporate parts of a previously lodged compliance plan as that first plan is amended from time to time. This assists in preparing and amending of compliance plans. See [CO 98/50].

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**How to lodge a compliance plan**

You can lodge an application to register a managed investment scheme at your nearest ASIC Regional Office.

You can also contact the ASIC Infoline on 1300 300 630 for information and assistance.

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## Underlying principles

**[PS 132.6]** Under the Law, the compliance plan for a scheme plays a key role in the range of measures designed to protect scheme members. We believe that our approach should therefore focus the preparation of compliance plans on:

(a) the characteristics of the individual scheme; and

(b) the protection of scheme members.

## Explanations

### *Preparing a compliance plan*

**[PS 132.7]** We consider that the purpose of a compliance plan is to describe how a responsible entity will make sure that it is complying with the Law and the scheme constitution. We therefore consider that a compliance plan should list the key processes, systems and structures that the responsible entity will apply. For example, a compliance plan should set out the processes, systems and structures by which a responsible entity will continuously review how it is complying with its obligations under the Law and the scheme constitution.

**[PS 132.8]** Under the Law, a compliance plan must set out adequate measures that a responsible entity will apply to make sure that it complies with the Law and the scheme constitution: s60lHA. This section sets a very high standard of content for compliance plans. We consider that this does not mean that every requirement of the Law or the constitution should be dealt with exhaustively or in the same level of detail. The individual characteristics of each scheme will affect what is the appropriate content of a compliance plan for that scheme.

[**PS 132.9]** In addition to the mandatory matters listed in s60lHA(1) and s601HA(2), there will be many other matters which deserve serious treatment in a compliance plan. The Law is designed to ensure that the interests of investors are protected. A compliance plan should therefore reflect:

(a) the major compliance risks which investors face; and

(b) the abuses potentially associated with conducting schemes.

**[PS 132.10]** To ensure that the interests of investors are protected, when you prepare a compliance plan you should undertake a structured and systematic process which:

(a) considers the obligations under the Law and the constitution affecting the responsible entity;

(b) identifies risks of non-compliance; and

(c) establishes measures designed to address these risks.

**[PS 132.11]** This would involve, at a minimum, responding to the following general questions:

(a) What are the responsible entity's obligations under the Law and the constitution for this scheme? What outcomes are the Law and constitution designed to deliver?

(b) What risks to ongoing compliance are posed by the operations of this particular scheme given the nature of the scheme, its environment, its size, its members, its asset types etc?

(c) What is the likelihood and impact of failing to deliver this outcome against other outcomes? Therefore, how should compliance efforts be focused?

(d) What compliance measures will deliver the intended outcome?

**[PS 132.12]** The specific obligations of the Law and the constitution referred to in para (a) of [PS 132.11] can be analysed in terms of appreciating the risks to members. Members' interests will not be protected if there is a failure in any one of a number of key areas. Those key areas fall under a number of general headings, but would include, at a minimum, ensuring that:

(a) scheme property is held in a way that minimises the risk of loss by misappropriation or through insolvency of the responsible entity;

(b) the interests of the responsible entity or its related parties are not placed above the interests of the member;

(c) the responsible entity and its officers and employees, will not profit from improper use of information;

(d) there is adherence to the scheme's investment policy;

(e) members are told all information necessary for them to make decisions about their holdings;

(f) scheme members of the same class are treated equally and all scheme members are treated fairly; and

(g) members do not suffer loss because the responsible entity, its officers or employees do not act with reasonable care and diligence or otherwise fail in their duties to the scheme.

**[PS 132.13]** The measures identified under a process such as that described in [PS 132.7]—[PS 132.12] should be documented in the compliance plan. They should be documented in a way that meets the detail requirements set out under the heading *Level of detail* in [PS 132.17]—[PS 132.19].

**[PS 132.14]** We will actively assess compliance plans when we are deciding whether or not to register a scheme under s601EB(1). We will consider, in the context of the type of scheme, whether the responsible entity has designed measures which adequately address the risks of not complying with its obligations. For example, a responsible entity must continuously monitor, review and audit the outcomes of its compliance activities. We will therefore assess whether the responsible entity's arrangements for doing this are adequate.

***No ASIC checklist***

**[PS 132.15]** A compliance plan should focus on the measures and processes to achieve compliance outcomes including ongoing compliance. These outcomes will depend on the type of scheme. For this reason, we will not give checklists of detailed measures which should be included in a compliance plan.

**[PS 132.16]** A list of some illustrative outcomes is in the Annexure to this policy statement at [PS 132.25]. It gives some guidance on the types of outcomes which might typically, as a result of the suggested process, be addressed in a compliance plan. The matters in the Annexure are not relevant to all scheme types. Nor are the suggested types of measures always suitable for addressing the outcomes. The list is included merely as an aid for preparing a compliance plan. It may help you to assess if the processes you use to prepare the plan are sufficiently robust.

***Level of detail***

**[PS 132.17]** ASIC and the auditor of the compliance plan must be able to assess whether or not a responsible entity has complied with its compliance plan. A compliance plan lodged with us must describe compliance activities with enough detail and certainty for the auditor and ourselves to assess, at a later time, whether or not the plan has been complied with.

**[PS 132.18]** Therefore, measures must be described in a way which represents more than mere platitudes or broad ambitions of compliance. Conversely, this does not necessarily mean that a compliance plan should detail each and every step, check, detailed procedure or action.

**[PS 132.19]** Several illustrations on how measures might be described in a compliance plan are included in the Annexure to this policy statement at [PS 132.25]. These are included for guidance purposes only. They do not necessarily set out measures that will be applicable for any particular scheme. When deciding on what level of detail to include, you should consider how the responsible entity, the auditor and ASIC will use the compliance plan.

***Incorporating parts of other plans***

**[PS 132.20]** After registering one scheme, a responsible entity may want to register further schemes. In this situation, any part (typically the general part) of the first scheme's compliance plan may be incorporated by reference into the compliance plan for other schemes: s601HB(1). The words *"as in force at a specified time"* in s601HB(l) and (2) mean that it is only possible to incorporate parts of that other plan as they existed at a specified date. This means, for example, if the first plan is amended, this will not result in the parts that have been incorporated into the later plan being amended as well. That later plan would have to be modified itself: s601HE(3).

**[PS 132.21]** The incorporated parts of compliance plans will logically be those parts which have common operation across several schemes. Therefore, we have modified the Law so that a compliance plan can incorporate parts of a previously lodged compliance plan as amended from time to time. We have done this so that the incorporated parts of the second, or subsequent, plans are amended as the first plan is amended. See [CO 98/50].

**[PS 132.22]** The modification to the Law will only have effect however when the compliance plan which incorporates parts from another plan uses words to the effect that the responsible entity will review the appropriateness of the plan at the time that any amendment is made to the part that is incorporated.

## Key terms

**[PS 132.23]** In this policy statement, a reference to:

"ASIC" is to the Australian Securities and Investments Commission;

"the Law" is to the Corporations Law;

"scheme" is to a registered managed investment scheme or to a proposed registered managed investment scheme;

"responsible entity" is to a responsible entity of a scheme; and

"s782" (for example) is to a section of the Law.

## Related information

**[PS 132.24]**

**Headnotes**

Managed investment schemes, compliance plans, assessing compliance plans, adequate measures, structured and systematic process, incorporating by reference, incorporation by reference, illustrative outcomes, detail of compliance plans.

**Class orders and pro formas**

[CO 98/50]

**Policy statements and practice notes**

Policy Statement 130 *Managed investments: Licensing* [PS 130]
Policy Statement 131 *Managed investments: Financial requirements* [PS 131]
Policy Statement 133 *Managed investments: Scheme property arrangements* [PS 133]
Policy Statement 134 Managed investments: Constitutions [PS 134]
Policy Statement 135 Managed investments. Transitional issues [PS 135]
Policy Statement 136 Managed investments: Discretionary powers and closely related schemes [PS 136]

**Legislation**

s601EA, 601EB, 601HA, 601HB, 601HE

**Policy proposal papers**

Licensing a responsible entity
Financial requirements of a responsible entity
Compliance plans for managed investment schemes
Scheme property arrangements
Constitutional issues
Transitional issues
Exemptions and modifications

**Media and information releases**

[IR 98/9], [IR 98/10]

**Annexure**

**[PS 132.25]**

This Annexure to Policy Statement 132 gives some guidance about two aspects of compliance plans. While developing this policy statement, we were asked by some industry participants for some general guidance on what to put in a compliance plan.

Accordingly, we have set out below:

(a) a list of some outcomes which might typically, as a result of the process suggested in paragraphs [PS 132.7]—[PS 132.12] of the policy statement, be addressed in a compliance plan, and

(b) some guidance on how compliance measures might be described in a compliance plan.

It is not suggested that the matters in these lists are relevant to any particular scheme nor that they are exhaustive. The outcomes and measures which are relevant to a particular scheme can only be ascertained by undertaking a review process along the lines set out in the policy statement. The two lists will however give you guidance on our current thinking on these issues, and the types of matters which we will have regard to in assessing the adequacy of compliance plans.

We will review these examples in light of our experience in administering the Law.

***Examples of outcomes which might be addressed in a compliance plan***

**1 Safekeeping and segregating scheme property**

| | |
|---|---|
| *(a) Identifying scheme assets* | What controls ensure that scheme assets are identified appropriately? |
| *(b) Separating scheme assets* | What are the controls to ensure that scheme assets are separated from those of the responsible entity and other schemes as required under the Law? |
| *(c) Third party custodians* | What arrangements are in place to ensure that any person (other than the responsible entity) holding scheme property meets ASIC's standards for holding scheme property? |

*Policy Statement 133 considers in more detail standards for custodians of scheme property: see [PS 133.2].*

**2 Directors or compliance committee**

| | |
|---|---|
| *(a) Responsibilities* | What procedures ensure that members of the board or the compliance committee (as appropriate) are appropriately skilled, and have access to all information, reports and resources necessary for them to fulfil their responsibilities? |
| *(b) Compliance committee* | If a compliance committee is required, what arrangements (such as for remuneration, tenure, frequency of meetings) ensure that the committee functions as required by s601HA(b)? |

| | | |
|---|---|---|
| *(c)* | *Compliance officer* | If a compliance officer is appointed what measures ensure that that person has adequate authority to escalate matters if necessary? What measures ensure that compliance staff are adequately trained and independent? |

*Policy Statement 136 gives some guidance on the meaning of the phrase "substantially involved in business dealings, or in a professional capacity, with the responsible entity": see [PS 136. 76A]—[PS 136. 76E].*

*[Historical note: Inserted 4/11/1998.]*

**3 Valuation issues: 601FC(1)(j)**

| | | |
|---|---|---|
| *(a)* | *System/approach used for calculating unit price* | What are the controls to ensure that the systems used to determine unit price are functioning consistently with the scheme's offering document, that the offering document is consistent with the scheme's constitution and that supporting systems (eg system for processing unit buying and selling activities) are adequately operated? What procedures are in place to correct pricing errors? |
| *(b)* | *Systems/approach used in valuing investments* | How does the responsible entity ensure that the scheme property is valued at regular intervals appropriate to the nature of the property? How does the responsible entity ensure that the scheme property is valued in a manner appropriate to the nature of the property? |
| *(c)* | *Collecting income* | What controls ensure that income earned by scheme assets is collected and recorded in a way which is timely, accurate and complete? |
| *(d)* | *Identifying and recording of corporate actions* | What controls ensure that the scheme becomes aware of changes in security values, positions etc due to corporate actions on a timely basis so that changes in valuations, income accruals, and positions can be evaluated? |

**4 Audit**

| | | |
|---|---|---|
| (a) | *Audit resources* | What role will internal audit have in the compliance process and to what extent will the external auditor report beyond the annual compliance audit requirement? |

**5 Accounts and record keeping**

| | | |
|---|---|---|
| *(a)* | *Record keeping* | What controls ensure that accounting records and other evidence about the responsible entity's operation of the scheme will be adequate to allow the responsible entity and |

| | |
|---|---|
| | ASIC to conduct reviews of scheme activities? What procedures ensure that appropriate accounting and taxation requirements are adhered to? What procedures ensure all that statutory deadlines for reporting are adhered to? |
| *(b) IT and accounting systems used by the responsible entity* | What arrangements ensure that IT and accounting systems used by the responsible entity are secure and meet the operational requirements of the scheme? |
| *(c) Custody IT systems* | If the responsible entity holds scheme assets, what arrangements ensure that the IT systems used for identifying and recording scheme property are secure and meet ASIC's standards? |
| *(d) Omnibus accounts* | If the responsible entity holds scheme assets, what arrangements ensure that any omnibus accounts operated are conducted under the terms of ASIC relief? |
| *(e) Business continuity and disaster recovery planning* | What are the responsible entity's plans for ensuring its ability to resume operations if a disaster occurs (eg a computer systems failure)? |
| *(f) Record retention* | What are the controls to ensure that records are maintained for the statutory period? What procedures ensure that records of all compliance monitoring are kept? |

**6 Applications, redemptions and distributions**

| | |
|---|---|
| *(a) Application* | What controls ensure that applications are processed in a timely manner and are invested in the correct scheme at the correct price? What controls protect application monies before they become scheme property? |
| *(b) Withdrawals* | What are the controls to ensure that withdrawal prices are set so as not to disadvantage remaining scheme members? |
| *(c) Distributions* | What controls ensure that distributions to members are calculated correctly and made in a timely manner? |

**7 Conduct of business issues**

| | |
|---|---|
| *(a) Timely and best execution of trades* | What are the controls to ensure that trades executed on behalf of the scheme are performed on a timely basis (in real terms and in relation to other client accounts of the responsible entity), and at the best price available? |
| *(b) Timely and fair allocation of trades* | What are the controls to ensure that scheme trades receive fair allocations when block trades are made? How does the |

| | |
|---|---|
| | responsible entity ensure that allocations are completed without bias for or against any particular client or scheme? |
| *(c)* *Investment objectives* | How will the responsible entity ensure compliance with the scheme's investment strategy, mandate or restrictions? |
| *(d)* *Investment risks (liquidity, market volatility, counterparty)* | What are the controls to ensure that the responsible entity manages investment risks as specified in the scheme constitution and/or offering document? |
| *(e)* *Fund borrowing/ securities lending* | If applicable, what measures are in place to ensure that the scheme will not lose assets from any security lending arrangements? |
| *(f)* *Churning of securities* | What controls ensure that the responsible entity's levels of securities trading on behalf of the scheme are appropriate and that scheme assets are not wasted on brokerage? |
| *(g)* *Responsible entity interests in schemes* | What measures ensure that any potential conflicts of interest caused by the responsible entity, its affiliates, or directors owning interests in the scheme are appropriately managed? |
| *(h)* *Commission rebates and other inducements* | If the responsible entity participates in rebate programs with brokers, what are the controls to ensure that commission rebates are credited back to the scheme and are not retained by the responsible entity or credited to another client of the responsible entity? |
| *(i)* *Property trust specific obligations* | What procedures ensure completeness and timeliness of rental collections; that expenditure is appropriately authorised and in accordance with the constitution; that valuation methodologies and frequencies are appropriate; that borrowings are within defined limits? |
| *(j)* *Insurance of assets* | What measures ensure that appropriate insurance is in place for all identifiable risks relevant to the nature of the scheme's assets? |

**8 Disclosure and reporting**

| | |
|---|---|
| *(a)* *Advertising* | What procedures ensure that publicity (including advertising, media releases etc) which includes performance information, is not misleading? What procedures ensure that no material is published in breach of s1025? |
| *(b)* *Prospectus* | What procedures ensure that the prospectus or other public offer document contains all relevant information and is not |

| | |
|---|---|
| | misleading? What are the procedures to ensure that representations made in the offer document are carried out? |
| *(c)* *Reporting* | What are the procedures to ensure that the financial statements are true and fair and, when relevant, appropriate continuous disclosure is made? |
| *(d)* *Member reporting* | What procedures ensure that disclosure and reporting to scheme members is not misleading? |

**9 Related party issues**

| | |
|---|---|
| *(a)* *Functional separation of group operations* | What are the controls to ensure that information flows between companies within a group are appropriately protected? |
| *(b)* *Use of related brokers, banks and other service providers* | What are the controls to ensure that the decision to use a related party service provider is in the best interests of the scheme? |
| *(c)* *Underwriting* | What are the controls to ensure that if the responsible entity or a related party underwrite the issue of securities, any allocation to a scheme is in the best interest of the scheme, particularly in relation to the allocation of shortfalls? |
| *(d)* *Trading on inside information* | What are the controls to ensure that information obtained about the responsible entity's intentions to trade in specific securities is not used by employees for their own benefit? |
| *(e)* *Personal and house account dealing* | What controls ensure that dealings by the responsible entity or its employees do not disadvantage the scheme or free ride on it in any way? |

**10 Fees and expenses**

| | |
|---|---|
| *(a)* *Fees charged are authorised* | What are the controls to ensure that only authorised fees are charged to the scheme and that fees are calculated and deducted correctly? |

**11 Use of external service providers**

| | |
|---|---|
| *(a)* *Selection of external service providers* | What are the procedures to ensure that the use of third parties will be appropriately evaluated? |
| *(b)* *Contracts* | What are the procedures to ensure that contracts with external service providers are appropriate? |
| *(c)* *Custodian* | What arrangements are in place to ensure that any external |

| | |
|---|---|
| | custodian used meets ASIC standards? |
| *(d)* *Monitoring* | What procedures will the responsible entity use to monitor the activities of external service providers to ensure that the service provider is complying with the scheme's constitution and the Corporations Law? |
| *(e)* *External service providers* | What procedures ensure that external service providers are meeting the terms of the contractual arrangements? |

**12 Complaints handling**

| | |
|---|---|
| *(a)* *Complaints handling* | What are the controls to ensure that complaints relating to the scheme or the actions of employees of the responsible entity are appropriately handled in accordance with the method set out in the scheme constitution? |

**13 Compliance**

| | |
|---|---|
| *(a)* *Compliance plan* | How will the responsible entity ensure that necessary changes are identified and that the compliance plan is updated for them and any changes in procedures? What arrangements are in place to ensure that the compliance plan adequately deals with new investment products and the changing regulatory environment? How will the responsible entity ensure that changes are reported to ASIC? |
| *(b)* *Licensing* | What measures ensure that, in operating the scheme, the responsible entity continues to comply with any conditions of its licence, for example meeting financial requirements? *(Policy Statement 131 discusses the financial requirements for responsible entities: see [PS 131.3])* |

**14 Identifying, rectifying and reporting of breaches**

| | |
|---|---|
| *(a)* *Identifying* | How are breaches identified and rated? |
| *(b)* *Rectifying* | What are the controls to ensure that all breaches in obligations are appropriately rectified? |
| *(c)* *Reporting* | What are the controls to ensure that all breaches are reported to the appropriate level of management, the compliance committee and the directors? What are the controls to ensure all breaches are reported to ASIC as required by s601JC(d)? |

**15 Training recruitment and experience**

| | |
|---|---|
| *(a)* *Compliance staff* | What procedures ensure that compliance staff have |

| | |
|---|---|
| | appropriate experience and have adequate resources? |
| *(b) Compliance plan* | What training is performed to ensure that existing and new staff are familiar with the compliance plan? |
| *(c) Staff competency* | What procedures are in place to ensure that only appropriate personnel hold positions of trust and that key staff are competent to perform their relevant roles? |

**16 Distribution channels**

| | |
|---|---|
| *(a) s849 and 851* | What measures ensure that sales/distribution staff comply with the know your client/know your product rules (s849 and 851)? |

*Examples of the detail which may be required in a compliance plan*

Calculation of unit price

What are the controls to ensure that the systems used to determine unit price are functioning consistently with the scheme's offering document, that the offering document is consistent with the scheme's constitution and that supporting systems (eg system for processing unit buying and selling activities) are adequately operated? What procedures are in place to correct pricing errors?

*Compliance plan example*

The unit pricing procedures are documented in a procedures manual (which has been approved by the compliance officer) and are subject to a detailed review by external/internal audit on a six monthly basis to ensure they are consistent with the prospectus/constitution.

Daily unit pricing calculations (which include details of all assets and liabilities of the scheme, and the number of units on issue) are approved by a person independent from the preparer.

Daily movements in unit pricing are reviewed and explained by a person independent from the preparer.

Any unusual or unexpected movements are reported to management and investigated by the compliance officer.

Errors identified are corrected in a manner consistent with IFSA's Guidance Note "Incorrect Pricing of Scheme Units".

Valuation of investments

How does the responsible entity ensure that the scheme property is valued at regular intervals appropriate to the nature of the property? How does the responsible entity ensure that the scheme property is valued in a manner appropriate to the nature of the property?

*Compliance plan example*

All equities are valued daily by way of automatic price feeds from a third party.

Manually priced stocks are identified as such, signed off by the head of the department and periodically verified against independent sources.

All valuations are viewed by scheme accountants independent of the portfolio managers.

The valuation procedures are regularly checked for consistency with the constitution by the compliance officer.

Any significant or unexpected fluctuations are reported to management and investigated by the compliance officer.

Collection of income

What are the controls to ensure that income earned by scheme assets is recorded in a way which is timely, accurate and complete?

*Compliance plan example*

A dividend diary incorporated into the system ensures dividend capture. Accrued income is compared to actual dividend income and differences investigated.

Interest income is accrued daily by the systems.

Management reviews daily income accruals and periodically checks projected and actual yields.

Audit

What role will internal audit have in the compliance process and to what extent will the external auditor report beyond the proposed annual compliance audit requirement?

*Compliance plan example*

Internal audit's role is set out in their internal audit charter. Their annual plan is discussed and agreed with the board audit committee. This includes a quarterly review of adherence to the content of the compliance plan.

The scope of the annual external audit of the compliance plan is set down in the auditor's engagement letter dated 1 July 1998. Terms of engagement are agreed annually with the compliance committee and the board audit committee.

Applications

What controls ensure applications are processed in a timely manner and are invested in the correct scheme at the correct price? What controls protect application monies before they become scheme property?

*Compliance plan example*

Application monies are banked into the applications bank account and are reconciled daily to application form monies recorded as received.

Application forms are checked for completeness, accuracy and relevancy.

Missing, incomplete or incorrect application forms are followed up with applicants within 24 hours.

Registry input data of application details and daily unit pricing are approved by an independent person.

Daily registry applications and redemptions are reviewed for reasonableness.

Application monies are transferred on acceptance to a scheme specific bank account.

Disclosure and reporting

What procedures ensure that the prospectus or other public offer document contains all relevant information and is not misleading? What procedures ensure that representations made in the offer document are carried out?

*Compliance plan example*

Each prospectus is subject to a rigorous due diligence procedure whereby all significant statements, all assertions and all financial data are subject to sign-off by senior management, external auditors and legal advisers as appropriate. The prospectus and supporting representations are reviewed and discussed at a due diligence committee meeting. The committee consists of three directors with attendance by the chief legal officer, the chief financial officer and external auditors.

Procedures to monitor representations made in the prospectus are covered elsewhere in this compliance plan.

## VIII. CONCLUSION

There is no consensus in Canada as to whether a new mutual fund governance regime is necessary or appropriate nor, if Canada is to have a new fund governance regime, what type of regime should be established. Evidence of this lack of consensus was most vividly brought to my attention when I received the first two responses to the questionnaire which I sent to the mutual fund industry (a form of which is annexed as Schedule A to Part II of this report). One of the two fund groups that first responded to the questionnaire indicated that no form of independent governing body was necessary as part of a new mutual fund governance regime in Canada and that there was no reason to require the manager to be registered, while the other fund group favoured an independent governing body and favoured manager registration. Additional discussions during the course of this report, as well as the responses I received to the questionnaire (summarized in Schedule B to Part II of this report), have confirmed this lack of consensus. Accordingly, of one thing I am sure: the recommendations in this report will not find acceptance in some quarters of the mutual fund industry and perhaps even with some members of the CSA.

As I previously stated, designing a governance regime is not a science but rather is an art. I do not believe that there is only one correct answer to the question of what governance regime should be established. One also should remember that better governance is not an end in and of itself but rather is a means to an end. With these thoughts in mind, I suggest that the CSA undertake a consultative process with the mutual fund industry to review and consider the recommendations in this report before they are adopted. In addition, these recommendations and whatever governance regime is implemented as a result of these recommendations should be re-evaluated in light of any future empirical evidence that is developed as to whether problems exist in the Canadian mutual fund industry, whether better fund governance leads to better fund performance and whether the governance regime is responsive to the other matters raised at the beginning of the Executive Summary portion of this report. The purpose of the re-evaluation would be to determine whether any of these recommendations or the adopted governance regime should be altered in light of such empirical evidence and thereby establish a more effective and efficient mutual fund governance regime.

I hope that the CSA and the mutual fund industry ultimately embrace these recommendations and that fund organizations improve upon and tailor these recommendations to the distinct circumstances of their mutual fund complexes. I know from personal experience that the Canadian mutual fund industry is extremely innovative and I would not be surprised if some fund organizations discover that they can use their models of mutual fund governance to assist them in marketing their sponsored mutual funds.

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