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Finance Area
Schulich School of Business
York University
4700 Keele Street
Toronto, Ontario M3J 1P3

Bus: 416-952-9996
Fax: 416-952-9997
E-mail: lawrence_schwartz@ca.telus.com

BY E-MAIL

Five-Year Review Committee
c/o Purdy Crawford, Chair
Osler, Hoskin & Harcourt LLP
Barristers & Solicitors
Box 50, 1 First Canadian Place
Toronto, Ontario M5X 1B8

Dear Mr. Crawford:

Thank you for your letter of May 29 attaching a copy of the Draft Report of the Five-Year Review Committee, and for inviting my comments. As with my previous submission to the Committee, I will limit my comments to the remarks and recommendations in the Draft Report on mutual fund governance.

I appreciate the consideration which the Review Committee accorded my previous submission and I do not wish to simply restate my views now. However, it is difficult to discuss the recommendations in the Draft Report without doing so to some extent.

1. My View

At footnote 269, the Draft Report does not capture my views fully: I am not opposed to an "independent oversight body". I certainly oppose the notion that it must automatically, and in all cases, be a corporate-style board of directors with the powers and liabilities associated with boards of business corporations. There may be other ways of achieving goals of regulators, but the Draft Report does not consider any such ways.

The materials I provided to the Review Committee include a published article of mine ("Governance American Style?", Investment Executive, October, 1995) in which I stated that certain types of mutual funds require corporate-style governance. Those funds include closed-ended funds and funds that invest in illiquid assets such as real estate. However, for conventional open-ended mutual funds holding marketable securities, I see additional costs and no real benefits to fund investors.

2. Relation to CSA Concept Proposal

It appears to me that the recent Concept Proposal issued by the Canadian Securities Administrators on mutual fund governance reform and the Draft Report differ significantly in the objective sought. Like the Stromberg and Erlichman Reports, the Draft Report is clearly critical of the *status quo* that has been in place since the 1969 Report of the Canadian Committee on Mutual Funds and Investment Contracts, and seeks to address apparent conflicts of interest by recommending, *inter alia*, corporate-style fund governance machinery.

However, the Concept Proposal has a different focus. As I understand it, it responds to the fund industry's insistence on reduced regulation and lower compliance costs. Securities regulators are prepared to accommodate the industry's concerns, but only if the potential conflicts of interest that would result are dealt with in a manner that regulators deem satisfactory. For example, the relaxation of the prohibition on the acquisition of shares of related parties would be predicated on the establishment of a "governance agency" that would review such investments.

Accordingly, the focus of the Concept Proposal is prospective, rather than historical. It offers a *quid pro quo* to the fund industry in order to address potential problems that could arise in the future as a result of accommodating the industry's demands. But for a few rhetorical phrases, it does not address perceived inadequacies of the prevailing governance arrangements. Supporting this distinction between the Concept Proposal and the previous reports, I note the following exchange that took place on Tuesday April 2, 2002 in the open question period that followed remarks by members of a panel sponsored by the Financial Services Program of the Schulich School of Business. R. Cowdery presented the Concept Proposal:

> **L. Schwartz**: I have only one question. Whatever happened to Stromberg and Erlichman?
>
> **R. Cowdery**: We decided we didn't need them.

I recall that a representative of the Review Committee attended this event.

Although I have some concerns with the Concept Proposal and have expressed these in my public response to it, I certainly accept that regulators should take steps to ensure that fund investors are protected when the regulatory regime is liberalized to meet industry demands for greater flexibility and lower costs. In my view, however, the fund governance recommendations of the Draft Report have a very different purpose. If the Review Committee feels that its recommendations support those of the Concept Proposal then, with respect, I must firmly disagree. Indeed, the recommendations in the Draft Report serve to highlight the continuing confusion as to the purpose of fund governance reform.

3. Termination of the Fund Manager

The Draft Report recommends that the governance body be empowered to terminate the manager for, *inter alia*, "poor performance". In this respect, it is the only report recommending that the right to terminate the manager be given to the governance body. For example, the Concept

Proposal recommends that the governance agency be able to call a meeting of unitholders to vote on termination. It states:

> A board of directors of a corporation has the power to remove and replace the chief executive officer of the corporation. People analogize fund governance to corporate governance and say that the governance agency will only have real powers or "teeth" if it can dismiss the fund manager. We think that this unilateral power in the hands of governance agencies is not practical for mutual funds. Investors invest in a specific mutual fund when they are comfortable with the fund manager. Dismissing the fund manager would not only subvert investor wishes, but would leave mutual funds virtually orphaned. Who would take over the management of the mutual fund? We believe governance agencies need to be able to initiate investor meetings—particularly where the governance agency has a significant problem with the fund manager—and be able to suggest a change in manager to investors. Giving investors the ultimate power to change the fund manager or decide a dispute is a more realistic approach.

The Erlichman Report also recommended that the fund board not have the power to terminate the manager, similarly the report of the Steering Group that reviewed the Stromberg report. My recollection is that the Stromberg report itself did not address this matter.

The Draft Report's recommendation on terminating the manager illustrates what I believe is its fundamental misconception of what a mutual fund is and why investors acquire fund units. In my view, fund investors seek to "buy the manager", not a share of the portfolio of securities which the investor could acquire on his/her own. The fund investor seeks to benefit from the experience, capabilities and reputation of the manager and to delegate the management of his/her funds. Viewed in this way, there is no real distinction between the fund and the fund manager. Rather, the "fund" is simply an investment policy offered by a professional manager hoping to attract some number of individuals with corresponding objectives. As long as redemption on demand at marked-to-market net asset value is available on a regular basis, the dissatisfied fund investor holds the option to "terminate" the fund manager on that basis.

It is surprising that the Draft Report would suggest that "poor performance" could be a basis for termination of the manager by the governance body. It is far from clear what constitutes "poor performance"; the individual fund investor is the best judge of what this may mean. There is little reason to allow a governance body, particularly a body that is not selected or removable by fund investors, to make decisions that individual fund investors can make, and apparently have for a long time, been making successfully for themselves.

The Draft Report's reason for doubting this approach apparently lies with its concern that exit is not effective because it generally attracts "negative economic consequences" (at p.109). The Draft Report does not elaborate, but it presumably refers to capital gains tax consequences and to deferred sales charges where they exist. To the extent that tax consequences are significant, they also obtain in stock exchange trading by individuals generally. Similarly, brokerage fees will be payable by the investor on the sale of shares. Yet, exchange-traded securities may offer much less liquidity than fund investors obtain through redemption on demand.

Anticipating the arguments that the Review Committee may have considered in this matter, there is no merit in the argument that individuals trading on the stock exchange have speculative motives and hence shorter-term horizons than fund investors, and are somehow not deterred by "negative economic consequences" of exit. Doubtless, many fund investors are long-term investors.

However, an investor will continue to hold a particular share or fund unit as long as it continues to meet his/her expected rate of return and portfolio objectives. To say that fund investors will be deterred from exit by these consequences, but that individual traders will not, is unsupportable absent evidence thereto.

Before concluding that "negative economic consequences" deter redemption by fund investors, the Review Committee should have reviewed the statistics on redemption in the mutual fund industry, and perhaps compared them in some rough way with patterns of trading by other investors. This comparison would be especially helpful when considering the effects of deferred sales charges particularly because, as I understand it, investors in such funds have the option to redeem up to 10% of their units per year without attracting the sales charge. I understand that such redemptions are routine.

I have not undertaken research into the impact of deferred sales charges on redemption and accordingly, I do not advocate policy change. Rather, I maintain, as did the Dey Report to the OSC in the early 1980's, that those who advocate policy change have the obligation to support it. Until this research is done, it will be difficult to support the views of the Draft Report, or indeed any of the other reports (Stromberg, Erlichman, Concept Proposal) that apparently reach similar conclusions regarding exit even if, in the final analysis, they do not recommend termination of the manager by the governance body.

4. Research and Evidence, Generally

The area of "negative economic consequences" is but one area in which the Draft Report would have been more convincing had it undertaken the relevant research. At the very least, it might well have recommended subjects for further research. The fact that the Review Committee did not do so suggests that it foresees no need for any such studies or confirming evidence. In this regard, the Draft Report takes the same approach as all of the other reports on mutual fund governance reform.

Yet the Draft Report contains recommendations that, like those of the Concept Proposal, would require the expenditure by the industry of millions and millions of dollars annually. There is little doubt in my mind that the industry would pass these extra costs on to fund investors whether by higher management fees or by direct charges to the funds. To its credit, the Draft Report acknowledges that there are virtually no publicly-reported cases of abuse in the mutual fund industry arising from self-dealing or conflict of interest allegations (p.112) and that the problems of concern may be "perceived or real" (ibid.). Yet, the Draft Report states that fund investors will recoup the added costs of governance bodies by the added vigilance on their behalf (p.113).

With respect, these statements are not entirely consistent. If there is no abuse arising from self-dealing or conflicts of interest, or if the problems are only "perceived", or if governance bodies have no special advantage in dealing with abuses compared to other less costly approaches, then the added costs to investors cannot be recouped by added vigilance. Indeed, the greater risk is that members of a governance body would insist upon additional protection in the form of legal opinions and special studies by experts or by management, not to protect investors but to protect themselves from any legal liability that may be imposed (as proposed, for example, in the Concept Proposal). Absent the type of abuse that governance bodies are especially well-suited to manage, these additional expenditures would compound the problem of wasted investor resources.

The only basis for proposing mandatory governance bodies is the reasonable belief that abuse is occurring or is likely to occur in the future, and that such bodies are the most cost-effective way to deal with such abuse. In my view, the Draft Report has not established this reasonable belief or the cost-effectiveness of its recommendations.

It may be, as the Draft Report states, that a "large number of mutual fund management companies support the principle of fund governance". However, it is not clear how the Review Committee reached this finding. Several comments received in response to the Concept Proposal may be relevant. As I read them,

- many managers do not support the principle, in part because they feel that the fund investors are "buying the manager"
- many of those who do support the principle (and IFIC in particular) feel that it should not be imposed without simultaneous identification of rules and regulations that will be relaxed or eliminated, so that the costs and benefits can be assessed and weighed
- several of those managers who do support the principle have already established such bodies voluntarily, suggesting that a voluntary approach may be desirable having regard to the costs and the lack of evidence of abuse
- it appears that none of the voluntarily-established bodies have the power to terminate the manager.

Clearly, what some management companies may support in principle will not necessarily translate into their support for the recommendations contained in the Draft Report.

At the same time, securities regulators should **not** wait until a serious problem develops before taking action. Rather, the appropriate conclusion at the present time is that if regulators have concerns in regard to self-dealing or conflicts of interest in the fund industry, then they should undertake the necessary investigation, draw appropriate conclusions and propose consequential reforms. Apparently, this is now being done. I understand from an interview in the press approximately a year ago with an OSC accounting official that regulators have begun a long-term review of individual fund companies and their internal practices. Although this review will not be completed within the mandate of the Review Committee, surely the Committee's final recommendations should be informed by whatever information that inquiry may provide. Indeed, the Review Committee should consider recommending deferral of its recommendations pending the early evidence therefrom.

The second example is the recent, apparently comprehensive, regulatory review of "high closing" in the mutual fund industry. On the basis of publicly-available information, I understand that that study concluded that the practice is not problematic in the fund industry.

It is apparent that the Draft Report does not make use of all of the information that is on the record. I regard its recommendations for mandatory governance bodies as premature.

5. Regulatory Forbearance

The Review Committee supports the introduction of fund governance reform by rulemaking authority of securities commissions. I do not question this procedure, but it overlooks a central issue that the Draft Report does not address, i.e. that any rules adopted for mutual fund governance bodies must necessarily reduce the scope of securities commissions.

It would be pointless to institute the governance reforms recommended by the Review Committee if securities regulators were not willing to allow the decisions of governance bodies to stand, even if regulators disapprove. In effect, once these rules are put in place, the appropriate regulatory stance is one of forbearance.

Historically, however, Canadian securities regulators have not hesitated to intervene on behalf of investors when the circumstances warranted. Yet, with governance bodies in place, one wonders what might happen if, for example, regulators sought to have a fund manager terminated but the governance body refused. Either governance bodies are empowered to act as they deem appropriate, or they are not.

The Erlichman Report highlighted this problem in the context of the approach subsequently taken by the Concept Proposal:

> 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. (op. cit., at 3)

The same issue attends the governance bodies advocated in the Draft Report. The more scope and authority are granted to the governance body, the greater is the deference to be accorded by securities regulators. There would be little reason to mandate the type of governance body suggested in the Draft Report if regulators were not prepared to routinely forbear in favour of such bodies.

In my view, the Draft Report should clearly point out that the requirement for governance bodies establishes a very different role for provincial securities regulators in the mutual fund area than they have traditionally had.

I would be pleased to discuss any of these comments with Review Committee, and in light of the Committee’s preference, I do not request confidentiality of this letter.

Respectfully submitted,

Lawrence P. Schwartz