1.1.2 OSC Staff Notice 81-713 – Focussed Disclosure Review – National Instrument 81-107 Independent Review Committee for Investment Funds

ONTARIO SECURITIES COMMISSION
STAFF NOTICE 81-713

FOCUSSED DISCLOSURE REVIEW
NATIONAL INSTRUMENT 81-107
INDEPENDENT REVIEW COMMITTEE FOR INVESTMENT FUNDS

INTRODUCTION

In March 2010, staff of the Ontario Securities Commission (OSC) ("Staff" or "we") concluded a series of focussed reviews of independent review committee (IRC) related disclosure and informal discussions with IRC members. We recently compiled and analysed our findings from these reviews and discussions.

The scope of the reviews was limited to disclosure related to National Instrument 81-107 – *Independent Review Committee for Investment Funds* (NI 81-107 or the Rule). Overall, we noted a high level of compliance with the disclosure requirements related to NI 81-107. We also received generally positive feedback from IRC members regarding their experiences with NI 81-107.

This notice summarizes our findings and general observations in the following areas:

- IRC fees and compensation,
- IRC composition and interaction with the fund manager, and
- the use of standing instructions.

The notice concludes with a brief discussion regarding applications for exemptive relief from the conflict of interest prohibitions in securities legislation and next steps for NI 81-107.

1. BACKGROUND

1.1 NI 81-107

NI 81-107 requires every investment fund that is a reporting issuer in Canada to have a fully independent body, the IRC, whose role is to oversee all decisions involving an actual or perceived conflict of interest faced by the fund manager in the operation of the fund.

Prior to NI 81-107, there was no requirement for investment fund managers to have any type of independent oversight over how they manage or monitor conflicts of interest. Several reports on investment funds and fund governance had concluded that the structure of the fund industry – where the investor's ownership of the fund is separate from the fund manager's management and control of the fund – creates the potential for the interests of fund investors to diverge from the pecuniary interests of the fund manager. This structure has the potential to cause a fund manager to act contrary to its fiduciary duty to the investment fund, and ultimately, to investors. NI 81-107 imposed a minimum, consistent standard of independent oversight for all publicly offered investment funds in each of the jurisdictions represented by the Canadian Securities Administrators (the CSA).

The Rule captures two types of conflicts that arise in the operation of an investment fund: (i) 'business' or 'operational' conflicts i.e. those relating to the operation by the fund manager of its funds that are not specifically regulated under securities legislation, except through the general duties of loyalty and care imposed on the fund manager under securities legislation; and (ii) 'structural' conflicts i.e. those resulting from proposed transactions by the fund manager with related entities of the fund manager, fund or portfolio manager currently prohibited or restricted by securities legislation.

The Rule requires the fund manager to establish written policies and procedures that it must follow when making a decision involving a conflict of interest matter and to refer the matter to the IRC for its recommendation or approval, as appropriate, before proceeding.

A decision by the fund manager to engage in certain transactions that comprise 'structural' conflicts must be approved by the IRC before the transaction may proceed. Approval by the IRC of each transaction may be provided on a case-by-case basis or take the form of a standing instruction. For any other course of action not restricted by securities legislation, but which raises an actual or perceived conflict of interest for the fund manager, the fund manager is required to refer the conflict of interest matter

to the IRC, which must then provide the fund manager with a recommendation that must be considered by the fund manager before proceeding.

NI 81-107 came into force on November 1, 2006 and its transition period ended on November 1, 2007.

1.2 Continuous Disclosure Reviews

Between September 2009 and March 2010, staff reviewed NI 81-107 related disclosure of a sample of 141 investment funds managed by 41 different fund managers, covering annual financial periods ending in 2008 and 2009, including: (a) the prospectus (long form or simplified prospectus as applicable to the fund); (b) the annual information form; (c) annual financial statements of the fund; (d) the IRC Report to Securityholders; (e) the annual management report of fund performance; and (f) the website of the fund manager or funds as applicable.

Fund managers included in the sample were selected for review based on criteria designed to reflect a fair representation of fund family size and fund type. Of the 41 fund managers reviewed, 21 were fund managers of conventional mutual funds with assets under management representing approximately 83% of total assets under management of conventional mutual funds. These fund managers had assets under management ranging from $46 million to $95 billion.

Of the remaining managers in the sample, 12 were fund managers of exchange-traded funds (ETFs) representing approximately 66% of the total market capitalization of ETFs listed on the TSX. We also reviewed flow through limited partnerships managed by 3 fund managers, labour-sponsored investment funds managed by 2 fund managers, and scholarship plans managed by 3 fund managers. In total, we reviewed 82 conventional mutual funds, 42 exchange-traded funds, 7 flow through limited partnerships, 6 labour sponsored investment funds and 4 scholarship plans.

1.3 Meetings with IRCs

During 2009, we also met informally with twelve IRCs of fund managers with assets under management ranging from approximately $950 million to $95 billion. Staff from the Compliance and Registrant Regulation branch of the OSC accompanied Investment Funds staff at these meetings.

The purpose of the meetings was to obtain general feedback from IRCs on five broad topics: (i) the IRC's relationship with the fund manager; (ii) the IRC's initial and ongoing orientation to the fund manager's business; (iii) the IRC's involvement in the fund manager's decision to apply for exemptive relief; (iv) the IRC's experience with standing instructions; and (v) general comments from the IRC on NI 81-107.

2. FINDINGS AND COMMENTS

In the course of our disclosure reviews, we gathered information with a view to assessing some of the key concerns expressed by the fund industry when we published the Rule for comment. Specifically, that IRCs would be expensive; it would be difficult to attract and retain IRC members; and the IRCs could undermine the fund managers' ability to effectively manage its funds. Our reviews revealed that:

- IRC fees represent a minimal portion of a fund's total net assets,
- all funds reviewed were able to create and retain an IRC under the Rule, and
- standing instructions on conflict of interest matters enable the fund manager to effectively manage fund operations.

We noted only one recurring disclosure deficiency of significance. In a number of instances, funds failed to disclose IRC fees as a separate line item in the funds' financial statements as required under NI 81-106 – *Investment Fund Continuous Disclosure* (NI 81-106). We discuss this briefly as well as some general observations on other topics below.

All fund managers received notice of our reviews and were advised of any deficiencies specific to the funds they managed that we observed during the course of our review.

2.1 IRC Fees and Compensation

2.1.1 IRC Fees

During the course of the comment process in the development of NI 81-107, concern was expressed about the costs associated with establishing and maintaining IRCs. Specifically, we were told that higher costs to investors caused by an IRC would reduce the overall competitiveness of the fund industry.

We found in our reviews that IRC fees and compensation across different sizes and sectors of the investment fund industry generally represent a minimal portion of a fund's total net assets, significantly less than the approximate 1% to 3% of a fund's total net asset value represented by the typical fund manager fee.

For fund managers we reviewed with assets under management of less than $500 million, IRC fees ranged between 0.000033% and 0.27% of total net assets of the fund. For fund managers with assets under management between $500 million and $5 billion, IRC fees ranged between 0.0005% and 0.096% of total net assets of the fund. IRC fees ranged between 0.000067% and 0.041% of total net assets of funds managed by fund managers with assets under management over $5 billion.

2.1.2 IRC Compensation

IRC Members

Overall annual compensation amongst IRC members we reviewed ranged between $0 and $50,000 per annum. We found that annual compensation of IRC members was highest, on average, for IRCs of fund managers with assets under management over $5 billion (i.e. $26,500 per IRC member).

Annual IRC member compensation for fund managers with between $0 and $500 million in assets under management ranged between $0 and $30,000. For fund managers with assets under management between $500 million and $5 billion, annual IRC member compensation ranged between $2,000 and $40,000. Annual IRC member compensation for fund managers with over $5 billion in assets under management, ranged between $10,000 and $50,000.

IRC Chairs

Overall annual compensation amongst IRC chairs we reviewed ranged between $0 and $75,000 per annum. Similar to IRC members, we observed that annual compensation of IRC chairs was highest, on average, for IRCs of fund managers with assets under management over $5 billion (i.e.$34,117 per IRC chair).

Annual IRC chair compensation for fund managers with between $0 and $500 million in assets under management ranged between $0 and $40,000. For fund managers with assets under management between $500 million and $5 billion, annual IRC chair compensation ranged between $2,000 and $50,000. Annual IRC chair compensation for fund managers with over $5 billion in assets under management ranged between $10,000 and $75,000.

2.1.3 IRC Fees Disclosure

The majority of fund managers we reviewed disclosed IRC fees as a separate line item in the fund's Statement of Operations. In a number of instances, however, IRC fees were combined in the Statement of Operations with other fees such as directors' fees, administration fees, trustees' fees and administration costs. In a few instances, IRC fees were not disclosed at all in the Statement of Operations.

One explanation given for the absence of this information was the fund manager's view that the IRC fees accrued were not 'material'. We remind fund managers that all IRC fees paid by the fund must be appropriately disclosed in the fund's financial statements as a separate line item from directors' fees, trustees' fees and other expenses, in accordance with section 3.2, Item 8.1 of NI 81-106. This disclosure requirement is intended to provide transparency of the amount of IRC fees that were specifically charged to the investment fund.

2.1.4 General Comments and Observations Regarding IRC Compensation

We did not find any IRC members who received indemnities from the fund or the fund manager in their capacity as IRC members.

The factors used to assess the level of compensation of IRCs were generally consistent across the IRCs of all funds in our sample and typically included three or more of the following factors:

- the best interests of the funds,
- the number, nature and complexity of the funds,
- the number of funds overseen by the IRC,
- that compensation paid by each fund to the IRC should reflect the benefits accruing to that fund,
- the fund manager's recommendation on compensation,

- comparative compensation amongst other IRCs i.e.industry practice,
- comparative compensation amongst other IRCs that oversee similarly structured investment funds with similar conflicts of interest,
- the results of the IRC's annual self-assessment,
- frequency of meetings of the IRC, time devoted by each IRC member and the workload of each IRC member, and
- the breadth and depth of the relevant experience of each IRC member.

We observed that fund managers used four different methods for allocating IRC fees among the funds they manage: (1) proportionately based on the total net assets of the fund; (2) equally among their funds; (3) based on the average number of securityholders and the average number of transactions per fund and per series for the period; and (4) at least two fund managers used a complexity factor to proportionately allocate IRC fees to their funds i.e. the more complex the fund structure, the greater proportion of total IRC fees allocated to that fund.

We also observed that four fund managers absorbed IRC fees. These fund managers had assets under management of more than $5 billion.

2.2 IRC Composition and Interaction with the Fund Manager

During the course of the comment process in the development of NI 81-107, concern was expressed about the availability of qualified candidates to serve as IRC members and that fund managers would face significant difficulty in finding qualified candidates. We did not observe any funds that were unable to create and retain an IRC with qualified members as required under the Rule.

2.2.1 IRC Composition

We found that a significant number of IRC members have expertise in the financial services industry. The size of the IRCs reviewed ranged between three members (the required number under the Rule) and nine members, with most of the IRCs reviewed having three members.

The mandate of almost all of the IRCs reviewed was limited to the Rule's mandate for the IRC to provide oversight of the fund manager's handling of conflict of interest matters. A few IRCs in the sample also act as advisory boards to the fund manager and/or to the funds more generally on a range of topics. In at least three instances, these latter IRCs were associated with fund managers with more than $5 billion in assets under management.

The majority of IRCs consulted had IRC members who sat on only one IRC. A few IRCs had at least one member who sat on two IRCs.

Almost all of the IRCs reviewed had no changes in composition for the fiscal years ending in 2008 and 2009. For the few IRCs that did experience changes in composition, the disclosure indicated that these changes were typically due to one or more of the following factors: (a) a change in control of the fund manager; (b) one or more IRC members ceasing to be independent; (c) expiry of IRC member terms or reduction of IRC size; or (d) change of fund manager.

2.2.2 IRC Independence

We found only a few instances that caused us to question the independence of IRC members. Fund managers and IRCs are reminded that to be independent, a member of an IRC must not have a material relationship which could be perceived to interfere with the IRC member's judgment regarding a conflict of interest matter (see the definition of "independent" in section 1.4 of NI 81-107). For example, we have questioned whether counsel that acts for the fund manager and/or the funds should act as an IRC member, given the pecuniary relationship that exists. Staff will continue in the normal course of our prospectus and application reviews to monitor the independence of IRC members.

A few IRC Reports to Securityholders provided detailed explanations of instances where IRC member independence could be called into question due to: (a) a specific conflict of interest of an IRC member which arose at the time (in which case the member resigned from the IRC); (b) aggregate ownership of IRC members in a specific fund of the fund manager beyond 10%; or (c) ownership or other involvement by IRC members in companies that provide services to the fund manager or the applicable investment funds.

One IRC Report to Securityholders disclosed that as part of its annual assessment, IRC members are required to complete an annual declaration that the member is "independent" as defined in section 1.4 of NI 81-107. We think the practice of an annual certification of independence by IRC members is beneficial and consistent with section 4.2(2)(a) of NI 81-107. We encourage IRCs to consider this approach.

2.2.3 Interaction with Fund Manager

The IRCs we met with told us that IRC members generally engage in active, constructive discussions with fund managers. Differences of opinion between IRC members and the fund manager are typically resolved by active debate and ongoing discussion until IRC members are satisfied that a conflict of interest is appropriately addressed and a reasonable result will be achieved for the funds.

IRC members told us that their fund managers support the ongoing education of IRC members by:

- facilitating attendance at seminars sponsored by law firms and private entities,
- making executive officers, portfolio managers, and sub-advisors available as needed to provide more information on a topic,
- providing news articles and press releases of interest on conflict matters, and
- including an education component at regularly scheduled IRC meetings.

We were also told that fund managers typically orient new IRC members to the fund manager's business by:

- providing written materials,
- introducing IRC members to members of each of the fund manager's business units,
- reviewing the IRC charter, and
- reviewing the conditions of any exemptive relief previously granted in connection with structural conflicts.

We did not find any instances where a fund manager proceeded with a conflict of interest matter without the positive recommendation of the fund's IRC.

In our reviews, we noted some inconsistency in disclosure by IRCs in the IRC Report to Securityholders of transactions which did not comply with a term of a standing approval of the IRC. In one case, the IRC Report disclosed a breach of a standing approval which was a transactional error caused by a sub-advisor to the fund. However, staff reviewed a similar instance where an IRC did not disclose a breach of a term of a standing approval in its IRC Report to Securityholders. The explanation given to staff for the lack of disclosure in the IRC Report was the fund manager's view that the transactional error was caused by a sub-advisor, not the fund manager, and was not 'material'. We remind IRCs that any known breach of a term of a standing approval issued by the IRC is required to be disclosed in the IRC Report to Securityholders by section 4.4(1)(h) of NI 81-107.

2.2.4 Use of Legal Counsel

While the majority of IRCs we met with advised that they have independent external counsel on retainer, most told us that to date there has not been a need for them to obtain advice from external counsel.

A few IRCs specifically mentioned their reliance on independent external counsel only for establishing the IRC charter and issues related to the indemnities of IRC members.

2.3 Standing Instructions

When we published NI 81-107 for comment, concern was expressed about the IRC potentially undermining the ability of a fund manager to effectively manage its funds by requiring it to constantly seek an IRC recommendation or approval. To address this concern, NI 81-107 permits the IRC to issue standing instructions on specific conflict of interest matters. We observed that standing instructions have been used in a variety of conflict of interest matters.

In our reviews, we found that most fund managers have standing instructions related to the following matters:

- Trading with a Related Broker-Dealer,

- Trading Aggregation and Allocation,
- Client Brokerage Commissions/Soft Dollars/Best Execution,
- Proxy Voting/Voting Procedures,
- Fund Valuation,
- Net Asset Value/Error Correction,
- Trust Accounting,
- Allocation of Fund Expenses,
- Personal Trading,
- Business Entertainment and Gifts,
- Portfolio Management and Investment Decisions,
- Related Issuer Purchases/Inter-Fund Trading,
- Fund Expense Policy (including Related Party Expenses),
- Excessive Trading Policy, and
- Changing Subadvisors or Service Providers.

We further observed standing instructions in some cases on a number of other conflict of interest matters, including:

- Fund on Fund Arrangements,
- Sales Practices,
- Unitholder Activity,
- Custody,
- Launching, Merging or Closing Funds,
- Fundamental Changes,
- Fairness Policy,
- Role of the Head Trader,
- Trade Error Correction,
- Transfer Agency/Error Correction,
- Administration Errors,
- Management Fee Rebates,
- Lending to Affiliate Borrowers,
- Benchmark Selection,
- Seed Capital Withdrawal,
- Commingling of Cash,

- Complaint Management,
- Client Privacy,
- Dissemination of Portfolio Information,
- Dual Employment Policy, and
- Indemnities for Independent Directors.

At least four IRCs we met with indicated that they review standing instructions quarterly in addition to the annual assessment required by section 4.2(1)(b) of NI 81-107. Reporting to the IRC of 'each instance' of the fund manager's reliance on the IRC's standing instructions also occurred quarterly in these cases.

A number of IRC members told us that amendments to existing standing instructions occur as needed, in response to market developments and the fund manager's request.

The IRC Reports to Securityholders reviewed provided a list of standing instructions issued by the IRC, however, only a few of these reports provided a brief summary of the actual or perceived conflict of interest that each particular standing instruction was intended to address. We think this practice is beneficial and encourage IRCs to consider this approach.

3. APPLICATIONS FOR DISCRETIONARY EXEMPTIONS FROM THE CONFLICT OF INTEREST PROHIBITIONS

Since the Rule became fully effective in November 2007, we have received a number of applications for discretionary relief from the conflict of interest prohibitions in securities legislation. These applications generally fall into one of three groups:

- reissued relief, which has consisted of revoking and replacing exemptions that were granted by the CSA prior to NI 81-107 coming into force with the terms and conditions updated to reflect NI 81-107 and the role of the IRC;
- relief analogous to the codified exemptions in NI 81-107 and NI 81-102, which has generally consisted of new relief that is granted on the same terms and conditions as the exemptions codified under NI 81-107 and NI 81-102; and
- new requests for discretionary exemptions not previously granted and beyond the scope of the exemptions codified in NI 81-107 and NI 81-102.

In each instance, the applicant has sought to rely upon IRC approval of the transaction as the basis for requesting the exemption. Most IRCs we met with told us that they are advised by the fund manager of its intention to file an exemptive relief application. Staff continue to encourage fund managers to advise their IRCs prior to applying for any exemptive relief. Generally, we expect:

- the IRC has been informed about the fund manager's intention and reasons for applying for relief,
- the application indicates that the IRC has been consulted, and
- the application indicates the IRC's view of the relief requested.

In the limited instances when new exemptive relief has been granted, the fund manager has been able to demonstrate a compelling market need for the exemption. In each instance, the relief has generally been limited in scope, and has included conditions that address objective and transparent pricing.

NEXT STEPS

Overall, we received positive feedback from IRC members regarding their experiences working with fund managers under NI 81-107. We also noted a high level of compliance with disclosure requirements related to NI 81-107. We intend to continue to monitor fund manager and IRC practices under NI 81-107 with a view to providing further guidance and notices as needed.

Staff will continue in the normal course of our prospectus and application reviews to inquire about the process and criteria used by an IRC to arrive at a positive recommendation or approval of a particular conflict of interest matter. Occasionally, this will include requesting the minutes of an IRC's discussion or materials related to a matter subject to its review, or asking to speak with the IRC or IRC Chair to discuss a specific matter.

Finally, Staff will continue to consider new applications for exemptive relief from the conflict of interest prohibitions in securities legislation on a case by case basis. Generally, Staff's view is that fund managers must demonstrate a compelling need or market necessity for the exemptive relief. We encourage fund managers and their counsel to contact us before proceeding with applications for exemptive relief not previously granted and beyond the scope of the exemptions codified under NI 81-107.

For further information or questions concerning this staff notice, please contact:

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