

2.2.4 AIC Limited - s. 127

**IN THE MATTER OF  
THE SECURITIES ACT  
R.S.O. 1990, C. S.5, AS AMENDED**

**AND**

**AIC LIMITED**

**ORDER  
(Section 127)**

**WHEREAS** on December 14, 2004, the Commission issued a Notice of Hearing (the "Notice of Hearing") pursuant to section 127 of the *Securities Act* (the "Act") in respect of AIC Limited (the "Respondent");

**AND WHEREAS** the Respondent entered into a settlement agreement with Staff of the Commission (the "Settlement Agreement"), in which the Respondent agreed to a proposed settlement of the proceeding commenced by the Notice of Hearing, subject to the approval of the Commission;

**AND UPON** reviewing the Settlement Agreement and the Notice of Hearing and Statement of Allegations of Staff of the Commission, and upon hearing submissions from counsel for the Respondent and for Staff of the Commission;

**AND WHEREAS** the Commission is of the opinion that it is in the public interest to make this Order;

**IT IS HEREBY ORDERED THAT** the Settlement Agreement dated December 14, 2004, attached hereto, is approved.

December 16, 2004.

"Paul M. Moore"

"Susan Wolburgh Jenah"

"Robert W. Davis"

**IN THE MATTER OF  
THE SECURITIES ACT  
R.S.O. 1990, C. S.5, AS AMENDED**

**AND**

**AIC LIMITED**

**SETTLEMENT AGREEMENT**

**I. INTRODUCTION**

1. By Notice of Hearing dated December 14, 2004, the Ontario Securities Commission (the "Commission") announced that it proposed to hold a hearing to consider whether, pursuant to section 127 of the *Securities Act* (the "Act"), it is in the public interest for the Commission to make an order approving the settlement agreement entered into between Staff of the Commission and the respondent, AIC Limited ("AIC").

**II. JOINT SETTLEMENT RECOMMENDATION**

2. Staff of the Commission ("Staff") recommends settlement with AIC (also referred to hereafter as the "Respondent") in accordance with the terms and conditions set out below. The Respondent agrees to the settlement on the basis of the facts set out in Part IV herein and consents to the making of an Order in the form attached as Schedule "B" on the basis of the facts set out in Part IV herein.
3. The terms of this settlement agreement, including the attached Schedule "A" and "B" (collectively, the "Settlement Agreement") will be released to the public only if and when the Settlement Agreement is approved by the Commission.

**III. ACKNOWLEDGEMENT**

4. Staff and the Respondent agree with the facts set out in Part IV herein for the purposes of this Settlement Agreement only and further agree that this agreement of facts is without prejudice to the Respondent or Staff in any other proceeding of any kind including, but without limiting the generality of the foregoing, any proceedings brought by the Commission under the Act (subject to paragraph 29) or any civil or other proceedings which may be brought by any other person or agency. No other person or agency may raise or rely upon the terms of this Settlement Agreement or any agreement to the facts stated herein whether or not this Settlement Agreement is approved by the Commission.

**IV. AGREED FACTS**

**a) The Respondent**

5. AIC is a fund manager responsible for the management of approximately 47 mutual funds ("AIC Funds") with assets under management of approximately \$12 billion (as of June 30, 2004).

**b) The Fund Manager's Duty**

6. A mutual fund manager is required by Ontario securities law to exercise the powers and discharge the duties of its office honestly and in good faith and in the best interests of the mutual fund and, in connection therewith, to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. Compliance with this duty requires that a mutual fund manager have regard to the potential for harm to a fund from an investor seeking to employ a frequent trading market timing strategy and take reasonable steps to protect a mutual fund from such harm to the extent that a reasonably prudent person would have done in the circumstances.

**c) Background**

7. In November 2003, the Commission, in co-operation with the Investment Dealers' Association of Canada and the Mutual Fund Dealers Association of Canada, began an inquiry into potential late trading and market timing in the Canadian mutual fund industry. The inquiry involved 105 Canadian mutual fund companies, and has been carried out in three phases. The inquiry is in its third and final phase, is expected to continue over the next several weeks and involves a number of mutual fund managers. AIC has cooperated fully in the Commission's inquiry.

8. In its review of AIC, Staff found no evidence of late trading occurring in AIC Funds. Staff has not found any evidence of market timing by any insiders of AIC or any evidence of ongoing market timing activity in AIC Funds. The following facts relate exclusively to market timing by certain third party investors in AIC Funds.

**d) Market Timing: Cause and Effect**

9. Market timing involves short-term trading of mutual fund securities to take advantage of short-term discrepancies between the "stale" values of securities within a mutual fund's portfolio and the current market value of those securities. Stale values can occur in mutual fund portfolios comprised, in whole or in part, of non-North American foreign equities (e.g. European, Asian and International and Global funds, also referred to herein as "foreign funds"). Stale values of those securities may result in stale values of the units of

a mutual fund as a result of the way in which the net asset value (“NAV”) of most mutual funds is calculated for the purpose of determining the price at which an investor may purchase or redeem (buy or sell) a unit of the fund.

10. The price of a mutual fund, in accordance with industry practice and as prescribed in the mutual fund’s Annual Information Form, is calculated at the close of each trading day (4:00 p.m. ET) by adding together the value of the assets of the fund (based on the most recent closing market price of securities in the fund’s portfolio), less any liabilities, and dividing that amount (the NAV) by the number of units held by investors in the fund on that day. Any order to purchase or sell a unit of the fund received by the order receipt office of the fund in good order prior to 4:00 p.m. ET will be executed at the NAV per unit calculated as of 4:00 p.m. that day. Any order to purchase or sell a unit of the fund received by the order receipt office of the fund in good order after 4:00 p.m. ET will be executed at the NAV per unit determined at 4:00 p.m. ET the following day.
11. The securities in a fund’s portfolio are each valued on the basis of their most recent closing market price as of 4:00 p.m. ET (the time at which North American markets close) on the day for which the NAV is being calculated. The closing market price of a foreign equity trading on an Asian market (which closed at 1:30 a.m. ET, for example) will have been determined 14.5 hours prior to the calculation of the foreign fund’s NAV. Similarly, the closing market price of a foreign equity trading on a European market (which closed at 12 noon ET, for example) will have been determined 4 hours prior to the calculation of the foreign fund’s NAV. Due to this lapse of time, the closing market price of the foreign equity used for the purpose of calculating the NAV of the fund may be “stale” and therefore the NAV of the foreign fund (and the unit price of the fund) calculated on the basis of that closing market price may also be “stale.”
12. There is a strong correlation between price movements of equities on North American markets (as reflected in movements in the S&P 500 index, for example) on one day and price movements of equities on foreign markets on the following trading day. Due to the time at which the foreign markets close, the price of foreign equities held in the portfolio of a foreign fund, and therefore the price of the foreign fund, will not reflect this pricing correlation until the following trading day.
13. A market timer will attempt to take advantage of the difference between the “stale” value and an expected price movement of the foreign fund the following day by trading in anticipation of those price movements. Portfolios that are known to have a material component of foreign equities that

are traded outside of North American time zones and that trade with a strong correlation with broad trends in price movements of equities on North American markets on the preceding day, afford the greatest “leverage” to investors using a market timing strategy.

**e) The Harm Caused by Market Timing of Mutual Funds**

14. When certain investors engage in frequent trading market timing in foreign funds, and when those investors are not required to pay a proportionate fee to the fund, the economic interest of long-term unitholders of these foreign funds is adversely affected. Significant harm may be incurred by a fund in which frequent trading market timing occurs. Any such harm would be borne by all investors in the fund. In addition to dilution<sup>1</sup>, market timing in a fund also may result in certain inefficiencies in that fund. Those inefficiencies, which will vary depending upon the particular fund, may involve increased transaction costs and disruption of a fund’s portfolio management strategy (including the maintenance of cash or cash equivalents and/or monetization of investments to meet redemption requirements) and may impair a fund’s long-term performance.

**f) The Disclosure of AIC Simplified Prospectus and AIF**

15. Specific statements contained in the Prospectuses filed by AIC for the years 1999 to 2003 (although not identical from year to year) disclosed that AIC could require the payment of a short-term trading fee of up to 2% in circumstances where an investor seeks to either switch between AIC Funds or redeem units of an AIC Fund within 90 days of having purchased the units.

**g) Market Timing in AIC Funds**

16. Three institutional investors holding accounts in AIC Funds have been identified as having profited as a result of frequent trading market timing strategies that were pursued in certain of the AIC Funds (the “Relevant Funds”) in the period from January 1999 to September 2003 (the “Market Timing Traders”). The Market Timing Traders traded in AIC Funds through one or more Canadian investment dealers.
17. AIC entered into agreements with three Market Timing Traders that contained the following basic terms:

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<sup>1</sup> Dilution of a fund’s value caused by market timing may be calculated by taking the percentage difference between the fund’s stale price and current market value multiplied by the amount invested.

- specific funds in which the three Market Timing Traders could invest were identified (ranging from 2 AIC Funds to 7 AIC Funds);
- a limit on the aggregate size of the investment that could be made (between \$20 and \$50 million) or a limit on the size of the investment that could be made, as a percentage of total assets of each fund (4%), was imposed;
- between 4 and 8 switches (a transfer of an investment from one fund to another fund) per fund per month were permitted;
- a fee of 2 basis points (0.02%) on all switches within the specified funds (based on the value of units being switched) was imposed. No fee was payable on switches into AIC money market funds. The fees were payable to the specified funds;
- where redemptions (as distinct from switches) occurred, a fee of up to 2% of the net asset value of the units being redeemed could typically be imposed, where redemptions exceeded maximum monthly limits. That fee would be paid to the fund;
- a termination clause permitting AIC to terminate the agreements on 3 days' or 10 days' notice; and
- a confidentiality provision.

There was no public disclosure of these agreements.

18. In August 2003, AIC advised the Market Timing Traders that they would be charged a 2% fee for switching. The Market Timing Traders ceased all frequent trading market timing trading in September 2003.
19. In the period January 1999 to September 2003:
- the total profit realized in AIC Funds by the Market Timing Traders (after deduction of the fees described in the last point below) was approximately \$127 million (not all of the profit realized by the Market Timing Traders was from frequent trading market timing transactions, and the profit realized by the Market Timing Traders does not equate to harm to other investors in AIC Funds);
  - the Market Timing Traders achieved a return on their overall investment in the Relevant Funds that was significantly

higher than the return that long-term investors would have achieved on their investments in the Relevant Funds in the same period;

- in connection with the trading by the Market Timing Traders, AIC charged management fees to the Relevant Funds of approximately \$3.1 million (net of trailer fees paid to Canadian investment dealers and other expenses, AIC earned \$0.9 million on those management fees); and
- fees of approximately \$0.5 million were charged by AIC to the Market Timing Traders and paid to the Relevant Funds.

20. In entering into the agreements referred to in paragraph 17 that permitted certain Market Timing Traders to engage in frequent trading market timing, AIC recognized some of the costs that could be incurred by the Relevant Funds as a result of the trading by the Market Timing Traders and implemented measures to protect the Relevant Funds against those costs. However, those measures (including the fees paid by certain Market Timing Traders to the Relevant Funds) adopted by AIC reduced, but did not negate, the harm resulting from the market timing activities. At the same time, AIC failed to recognize all of the costs (and, in particular, dilution) resulting from the frequent trading market timing activities of the Market Timing Traders and did not implement appropriate measures to protect the funds against the associated harm.

**V. THE RESPONDENT'S POSITION**

21. Effective August 2003, AIC adopted additional practices and procedures to prevent and detect market timing that could reasonably be expected to be harmful to AIC Funds and unitholders of AIC Funds.
22. AIC's current monitoring of trades in AIC Funds indicates that the policies and procedures that have been implemented have served to eliminate any potential adverse impact of frequent trading market timing.

**VI. CONDUCT CONTRARY TO THE PUBLIC INTEREST**

23. The agreements described in paragraph 17 protected the Relevant Funds from some, but not all, of the costs to those funds of the trading by the Market Timing Traders. Accordingly, the conduct of AIC in failing to protect fully the best interests of the Relevant Funds in respect of the frequent trading market timing was contrary to the public interest.

**VII. TERMS OF SETTLEMENT**

24. AIC agrees, as a term of settlement, that it will make a payment in the amount of \$58.8 million to Affected Investors (as defined in Schedule "A" to this agreement) through the distribution mechanism referred to in Schedule "A" to this agreement, and in accordance with the terms and conditions specified in Schedule "A" to this agreement.

**VIII. STAFF COMMITMENT**

25. If this Settlement Agreement is approved by the Commission, Staff will not initiate any proceeding under Ontario securities law in respect of any conduct or alleged conduct of AIC or its affiliates in relation to the facts set out in Part IV of this Settlement Agreement, subject to the provisions of paragraph 29 below.

**IX. PROCEDURE FOR APPROVAL OF SETTLEMENT**

26. Approval of this Settlement Agreement shall be sought at a hearing of the Commission on a date agreed to by counsel for Staff and AIC.

27. Staff and AIC may refer to any part, or all, of the Settlement Agreement at the Settlement Hearing. Staff and AIC also agree that if this Settlement Agreement is approved by the Commission, it will constitute the entirety of the evidence to be submitted respecting AIC in this matter, and AIC agrees to waive its rights to a full hearing, judicial review or appeal of the matter under the Act.

28. Staff and AIC agree that if this Settlement Agreement is approved by the Commission, neither Staff nor AIC will make any public statement inconsistent with this Settlement Agreement. Nothing in this section is intended to restrict AIC from making full answer and defence to any civil proceedings against it.

29. If this Settlement Agreement is approved by the Commission and, at any subsequent time, AIC fails to honour any of the Terms of Settlement set out in Part VII herein, Staff reserve the right to bring proceedings under Ontario securities law against AIC based on, but not limited to, the facts set out in Part IV of the Settlement Agreement, as well as the breach of the Settlement Agreement.

30. If, for any reason whatsoever, this Settlement Agreement is not approved by the Commission or an Order in the form attached as Schedule "B" is not made by the Commission, each of Staff and AIC will be entitled to all available proceedings, remedies and challenges, including proceeding to a hearing of the allegations in the Notice of Hearing and Statement of Allegations, unaffected

by this Settlement Agreement or the settlement negotiations.

31. Whether or not this Settlement Agreement is approved by the Commission, AIC agrees that it will not, in any proceeding, refer to or rely upon this Settlement Agreement or the negotiation or process of approval of this Settlement Agreement as the basis for any allegation against the Commission of lack of jurisdiction, bias, appearance of bias, unfairness, or any other remedy or challenge that may otherwise be available.

**X. DISCLOSURE OF AGREEMENT**

32. The terms of this Settlement Agreement will be treated as confidential by all parties hereto until approved by the Commission, and forever if, for any reason whatsoever, this Settlement Agreement is not approved by the Commission, except with the written consent of both AIC and Staff or as may be required by law.

33. Any obligations of confidentiality shall terminate upon approval of this Settlement Agreement by the Commission.

**XI. EXECUTION OF SETTLEMENT AGREEMENT**

34. This Settlement Agreement may be signed in one or more counterparts which together shall constitute a binding agreement.

35. A facsimile copy of any signature shall be effective as an original signature.

December 14, 2004.

"AIC LIMITED"  
AIC LIMITED

"Michael Watson"  
Staff of the Ontario Securities Commission  
Per: "Michael Watson"

**SCHEDULE A**

**PLAN OF DISTRIBUTION**

**The following terms pertain to the payment made pursuant to paragraph 24 of the Settlement Agreement. Terms defined in the Settlement Agreement and used in this Schedule have the meanings ascribed thereto in the Settlement Agreement:**

1. Respondent shall make a payment in the amount of \$58.8 million (the "Funds"), plus interest accruing from the date of approval of the settlement agreement to the date of the final approval referred to in subparagraph (ix), at the rate of 5% per annum, to the unitholders (including former unitholders) of the Respondent Funds that suffered harm from the market timing activities described in the Settlement Agreement (the "Affected Investors"), on the following terms:

- (i) Respondent shall,
  - (A) prior to the commencement of the hearing contemplated in paragraph 1 of the Settlement Agreement, pay \$15 million of the Funds to the Commission,
  - (B) on or before February 25, 2005, pay \$15 million of the Funds to the Commission, and
  - (C) on or before March 31, 2005, pay \$28.8 million of the Funds to the Commission.

The Funds shall be held by the Commission pending approval and implementation of the distribution to Affected Investors in accordance with subparagraphs (ix) and (xi) below;

- (ii) Respondent shall prepare a plan for distributing the Funds (the "Plan of Distribution"), the objectives of which are to accomplish a fair allocation of the Funds among the Affected Investors in a timely manner and in a manner the costs of which are reasonable in the circumstances;
- (iii) In connection with the preparation of the Plan of Distribution, Respondent shall retain, at its expense and subject to prior Staff approval, an independent consultant (the "Consultant"), to oversee the preparation of the Plan of Distribution;
- (iv) Respondent shall be responsible for all costs of preparing and implementing the Plan of Distribution and distributing the

Funds. The Funds shall not be applied toward any expenses of Respondent in connection with this settlement or its implementation;

- (v) Respondent shall cooperate fully with the Consultant and shall provide the Consultant with access to its files, books and personnel as requested for purposes of the Plan of Distribution;
- (vi) the Plan of Distribution shall include provisions which deal reasonably with circumstances in which the registered unitholders are not the beneficial owners of the units in question;
- (vii) the Plan of Distribution shall not result in any payment to unitholders described in paragraph 16 of the Settlement Agreement;
- (viii) Respondent shall, by September 30, 2005, deliver the Plan of Distribution to Staff for approval, together with a report of the Consultant that confirms that the Plan of Distribution was prepared in accordance with the principles contained in subparagraphs (ii) and (vi). Such date may be extended by the prior joint agreement of Staff and Respondent to allow for the obtaining of any rulings or completion of any discussions with Canada Revenue Agency in connection with the tax treatment of the receipt of compensation by Affected Investors considered necessary or advisable;
- (ix) the Plan of Distribution shall be implemented in accordance with subparagraph (xi) if approved by separate approval of (i) Staff, and (ii) the Chair and a Vice-Chair of the Commission;
- (x) each of Staff and the Chair and Vice-Chair of the Commission reviewing the Plan of Distribution in accordance with subparagraph (ix) shall approve the Plan, if, in their opinion acting reasonably, the Plan of Distribution was prepared in accordance with the principles contained in subparagraph (ii) and (vi);
- (xi) Respondent shall implement the Plan of Distribution within 3 months after the receipt of the last approval contemplated in subparagraph (ix);
- (xii) Respondent shall retain, at its expense and subject to Staff's approval, an independent consultant to monitor the

implementation of the Plan of Distribution; and

(xiii) Within 2 months of the completion of the implementation of the Plan of Distribution referred to in subparagraph (xi), the Respondent shall deliver to Staff:

(A) A report of the consultant retained under subparagraph (xii) in a form acceptable to Staff confirming that the distribution has been completed in accordance with the Plan of Distribution as approved under subparagraph (ix); and

(B) A certificate of the Chief Executive Officer of the Respondent confirming that the distribution has been completed in accordance with the Plan of Distribution as approved under subparagraph (ix).

2. If any of the terms set out in paragraph 1(i), (viii) or (xi) is not satisfied by the applicable date, the matter may be brought back before the Commission, for an order revoking or varying its decision pursuant to s. 144(1) of the Act.

3. If any of the payments set out in paragraph 1(i)(A), (B) or (C) are not made in full by the Respondent on or before the applicable date,

(i) in any enforcement proceeding that may be commenced following an order made pursuant to paragraph 2 revoking the Commission's decision, Staff shall be entitled to rely upon any admissions made by the Respondent in Part IV of the Settlement Agreement, but Staff shall not be restricted to the facts set out in Part IV of the Settlement Agreement;

(ii) Staff shall be entitled, at its option, to bring a civil proceeding to enforce the payment set out in the Settlement Agreement;

(iii) the Commission shall continue to hold such payments as were made by the Respondent pursuant to paragraph 1(i)(A), (B) or (C) pending final disposition of the earlier of any enforcement proceeding or any civil proceeding referred to in paragraph 3(i) or (ii) above. The final order in any enforcement or civil proceeding shall address the proper disposition of the funds so held by the Commission and the Respondent hereby agrees to comply with such disposition.

**SCHEDULE "B"**

**IN THE MATTER OF  
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R.S.O. 1990, C. S.5, AS AMENDED**

**AND**

**AIC LIMITED**

**ORDER  
(Section 127)**

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**AND WHEREAS** the Respondent entered into a settlement agreement with Staff of the Commission (the "Settlement Agreement"), in which the Respondent agreed to a proposed settlement of the proceeding commenced by the Notice of Hearing, subject to the approval of the Commission;

**AND UPON** reviewing the Settlement Agreement and the Notice of Hearing and Statement of Allegations of Staff of the Commission, and upon hearing submissions from counsel for the Respondent and for Staff of the Commission;

**AND WHEREAS** the Commission is of the opinion that it is in the public interest to make this Order;

**IT IS HEREBY ORDERED THAT** the Settlement Agreement dated December 14, 2004, attached hereto, is approved.

December 16, 2004.