SIPA
SMALL INVESTOR PROTECTION ASSOCIATION

A Voice for the Small Investor

August 10, 2005 email: csa-acvm-secretariat@lautorite.qc.ca

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Subject: Proposed National Instrument 81-107 [Rev 2]
Independent Review Committee for Mutual Funds

Dear Sir or Madam:

We are pleased to offer comment on proposed National Instrument 81-107 [Rev 2].

Recent exposure of widespread wrongdoing in the investment industry has shaken the confidence of small investors and has caused many to question whether they can place their trust in the industry. There appears to be a lack of compliance with mandatory requirements and investors are often disadvantaged by established industry practices.

The development of new investment products and sales practices outpaces the development of regulations. Industry lobbying appears to result in regulatory initiatives being watered down so that little progress is made in providing improved investor protection, and legislation that effectively erodes consumer/investor protection.

While we applaud the development of improved guidelines and recommendations, we fully realize that an industry that fails to follow mandatory rules and regulations and follows practices that vary from self developed codes of ethics and guidelines is unlikely to follow recommended practices and guidelines.

The OSC Town Hall Event in Toronto on May 31st, 2005 attracted approximately 500 people and vividly illustrates public concern about the industry's cavalier attitude towards small investors and their life savings, lack of investor protection ,and appropriate remedial measures when investors have suffered loss due to widespread industry wrongdoing.

Nevertheless, Ken Kivenko, Chair SIPA's Advisory Committee, has led a review of NI 81-107 and we now offer comments and recommendations for your consideration.

Mr. Kivenko is President of Kenmar Corporation, a management consulting company specializing in organizational performance enhancement and investor education and also operates a website (CanadianFundWatch.com). He publishes a monthly newsletter, The Fund Observer, and has authored papers relating to investment fund issues and corporate governance with particular emphasis on mutual funds.

Previously, Mr. Kivenko was the President and CEO of NBS Technologies Inc., Canadian Marconi Company, AlliedSignal Canada Inc. and Bendix Avelex Inc. He is currently a director of a number of public companies and a Governor of the National Quality Institute.

SIPA is pleased to submit these comments and we trust that the CSA will consider the needs of small investors in their review of any proposed revisions to regulations or legislation.

Yours truly

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The Small Investor Protection Association

Comments on

Proposed National Instrument 81-107 [Rev 2]

Independent Review Committee for Mutual Funds

August 10, 2005

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Letter from SIPA

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Chair SIPA Advisory Committee

SIPA Advisory Committee Chair Comments

We welcome the opportunity to again comment on proposals to improve investment fund investor protection and governance. We hope our feedback and ideas will prove useful to the CSA as it rolls out NI81-107.

A mutual fund is a unique investment product in that there is a fundamental conflict between the fund sponsor and the small retail investor, the most vulnerable and trusting of all investor classes. For every dollar paid to the sponsor, a corresponding dollar is lost in returns for the fund. Despite this, a mutual fund is often the best and only way for small retail investors to salt away money for a retirement nest egg or for a child's education via a diversified, professionally managed investment portfolio We note again the tremendous importance Mutual funds have on millions of people's lives via investments in RRSP's, RESP's, RRIF's, Defined Contribution corporate pension plans and open investment accounts. Approximately $500 billion is invested with about 50% of assets included in RRSP's. This is why mutual fund governance is so critically important to approximately 10 million Canadians who are mostly unsophisticated investors.

Mutual fund investors want to know that they can trust the fund managers to always act in the best interests of the fund and that they get a fair return for paying fees and incurring expenses. It is in this context that we will comment on this revision of NI81-107.

The mutual fund industry, and the Canadian industry is no exception, has experienced numerous failings over the years: defective internal controls, major information security breakdowns, front- running, high closing, deceptive advertising, inadequate disclosure, unsavoury sales contests and of course the now infamous market timing scandals .The Crocus (LSIF), Norshield and Portus hedge fund scandals alone have cost investors nearly a billion dollars in losses. KPMG has since determined that the fund did not invest about $52.8 million that it received from customers. The case is being investigated by the RCMP for potential criminal fraud. It is therefore most appropriate, timely and urgent to implement effective investment fund checks and balances to better protect Main Street investors.

At one time, the mutual fund was heralded as " the people's capitalism". This basic common sense approach to bringing professional money management to the small investor has evolved into a marketing juggernaut collecting over $10 billion in fees annually. Fund governance to protect investors is a critical regulatory need, but NI

81-107 Rev 2 goes only part way, despite the overwhelming evidence for greater reform.

NI 81-107 Rev 2 is a significant improvement over Rev 1 but is a real watering down of the earlier fund governance Concept proposal NI81-402 that industry representations successfully removed from the table. To a large extent regulators have listened to the investing public and are to be commended for eliminating the worst excesses of the earlier edition. The consistency of application between fund companies is one of the areas that it appears will be left to regulators to assure. We will comment on the second Draft proposal, identified here as Rev 2, but any commentary should not be considered as SIPA acceptance of IRC's as a fully adequate or final investor protection mechanism.

Comments on proposed Rule

First off, we'd like to see a linkage of the Instrument to specific Securities legislation in the Introduction section. The revised Instrument now encompasses mutual funds, including exchange-traded funds, scholarship trust plans, labour-sponsored investment funds, commodity pools, and venture capital funds. This expanded list is welcomed and sensible but we question why it would not also cover hedge funds.

The latter type of investment fund has already wreaked havoc on thousands of Canadians; the Portus fund alone extinguishing over $700 million of investor's savings .A Spring 2005 IDA report called for tighter Commission regulation of this class of pooled investment fund. We should not forget the 1998 collapse of the Long-Term Capital Management hedge fund. That crisis had so threatened to trigger a cascade of bond selling that the U.S. Federal Reserve had to jump off the sidelines to broker a U.S. $3.6 billion bailout to keep the financial markets stable.

We'd also like to see the CSA work with the Joint Forum to cover off segregated funds, which are really mutual funds with some insurance features thrown in. This is in fact stated to be the case in the latest OSC 2005-2006 Statement of Priorities.

The IRC, as proposed, will not be accountable to investors to ensure that securities laws (and other laws) and prospectus declarations are being complied with. Its role will be far more limited.

National Instrument NI81-107 Rev 2 - requires each fund manager to set up an Independent Review Committee (IRC) of at least 3 persons to look at conflicts involving the manager's commercial or business interests and its fiduciary obligations to the funds it manages for a fee. The fund must pay for this per 3.10 but the cost may be wholly or partially reimbursed. The gross cost of the IRC should be an isolable cost and appear as a separate line item on fund financial Statement of Operations for investor and other interested party visibility Re NI81-106.

The proposed committee would be expected to meet (we assume physically as opposed to videoconference or webcon) and report to unit-holders at least once a year. It would have the authority to require a manager who ignores its recommendations to notify securities holders at least 30 days before the effective date of the action. The committee would monitor and assess written policies and compliance with guidelines on conflicts-of-interest, and have the authority to report concerns directly to regulatory authorities.

We find Para 3.9 (e) encouraging the IRC to report to regulators any breaches of securities law, whether in or outside the IRC's responsibility scope, when they have a reasonable basis for suspecting abuses are occurring. Overall, we regard this structure as an improvement but basic, and certainly far less than has been recommended by a series of reports and studies going back more than a decade.

The inherent conflicts involve structural conflicts and business conflicts. The Appendix B flow chart [pg 71] delineates that only conflicts-of interest referred to the IRC by the manager will be reviewed. The manager may not be aware of all conflicts-of-interest, the manager may wrongly assess a situation and/or the manager may deliberately, for whatever reason, not be forthcoming with a referral. We would like clarification here to ensure that common sense, auditor observations, committee concerns, whistleblower sources, media reports or customer complaints could initiate an independent pro-active investigation of a potential or suspected conflict-of-interest and a decision by the IRC. As an example we observe that customer complaint information is an invaluable source of potential abuses/customer dissatisfaction. We understand for example that at least in one case, a sharp investor questioned high fund redemption ratios in an Asian fund back in 2001 but unfortunately his concerns and suspicions were not addressed, ultimately leading to the massive market timing scandal.

The market timing scandal is a case in point where fund manager's knowingly and in some cases aggressively permitted long-term investor return skimming and

obviously did not report these activities to trustees or advisory governance boards or ask for any decision. Given what we now know about the market timing issue, an IRC as proposed, would likely not have prevented the scandal since market timing is not clearly a conflict-of-interest issue, the issue was not referred to trustees and in a sense is not definitively illegal. It was a major breakdown in fund governance by knowingly accepting a defective valuation process (a governance issue in its own right especially in LSIF's with non-public and/or illiquid securities) and then allowing it to be exploited by a select few preferred customers.

There is thus a view that market timing would not have been brought to the attention of an IRC per the current version of NI81-107 because in some cases at least there was no direct conflict-of-interest, just a willingness to let a large customer effect transactions that were injurious to long-term retail investors but not strictly illegal or inconsistent with shrewdly worded prospectus language.
If this view is correct then a better definition of conflict-of-interest than 1.3 (1) and (2) or enhanced commentary may be in order if such scandals are to be prevented in future by application of NI81-107.

Of the five fund companies ordered to pay investor restitution by the OSC, it is now a matter of record, that no conflict-of-interests regarding market timing abuse were referred to any existing trustee, governance board or IRC over the four-year period ending Sept. 2003 to stop the practice.

In fact, it was really only when NY Attorney General Elliot Spitzer announced his actions against U.S. fund companies in Sept. 2003 that the practice came to a halt in Canada. Given this fact, can we expect a fund manager to be a reliable <u>sole</u> source for conflict-of-interest referrals? Is it fair to expect IRC's to sit passively by without decisive action even as it is aware of investor abusing practices, and thereby exposing themselves to public criticism or even legal liability? We recognize that the IRC may contact regulators directly but there would be an inevitable time delay and relationships would be negatively impacted.

The IRC should have the obligation and right to initiate an Action Request before contacting regulators or law enforcement when suspicious activity is observed. The manager would either have to deal with the conflict or show cause why it does not require resolution. This pro-active approach enhances the IRC stature and investor perceptions and allows for the maintenance of positive cost-effective relationships with the manager.

We believe the Instrument should delineate the most prevalent examples of conflicts-of-interest to illustrate and clarify the intent and scope of the IRC mandate. This could be in the body of the text as Commentary, a Companion Policy/Interpretation Bulletin or as an Appendix. There is also the question whether fund valuation, the root problem that permitted the time arbitrage abuse and the Crocus LSIF fund scandal, should not be included in the IRC's mandate or as a separate provision in a NI81-102 revision. The case has been turned over to the RCMP for criminal investigation.

In May, 2005 Manitoba's Auditor General (AG) concluded that the board of directors and senior managers of Manitoba's Crocus Investment Fund, a LSIF, failed to fulfill their responsibilities to the fund. AG Jon Singleton's report found serious weaknesses in the fund's governance and operations. Singleton identified several issues, including:

- A lack of oversight by the fund's board of directors.
- Flaws in the fund's investment procedures.
- Abuse of the fund's travel and expense policy.
- The value of the fund's assets appears to have been overstated.

The 240-page report stated: "My report should not be read as an indictment of venture capital investing or of [labour-sponsored investment funds]. Rather it should be read with a view to identifying opportunities to improve LSIF governance, and as a source of reference for improving the LSIF legislative framework in Manitoba."

NI81-107, which now embraces LSIF's, is missing the opportunity to make the necessary legal and regulatory improvements so aptly justified by the Manitoba AG's report. We suggest the CSA consider the recommendations contained in Attorney General Jon Singleton's Report and harvest the lessons learned.

A July 27, 2000 CSA News Release available on the OSC website http://www.osc.gov.on.ca/About/NewsReleases/2000/nr_20000727_fundgovernace.jsp) "CSA Releases Report on Fund Governance" states that a recommendation stemming from John Erlichman's report *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, included one requiring a fund compliance plan. Specifically the CSA/OSC release stated:

"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. The review should be conducted by the governance body and, if the governance body or the CSA wish, by an external auditor."

Several observers have noted that a requirement that investment funds adopt a compliance plan for the protection of investors might have averted the recent market timing scandal. The latest version of NI81-107 does not require such a plan although nearly five years have passed. In our view such a plan is so fundamental to the success of the IRC, that a Compliance Plan should be mandated in the Instrument.

The latest NI81-107 revision para 5.2 now requires the committees to pre-approve fund manager decisions in three defined situations: *interfund trading, purchases of securities of related issuers and purchases of securities being underwritten by a related underwriter*. It's not obvious how transactions involving short selling are dealt with but presumably they are captured under para 5.2 or para 5.3. Clarification might be helpful.

It is expected that the IRC would impose conditions on its approvals that would be subject to some sort of independent follow-up audit by the committee or by an extended external auditor audit mandate. If no audit requirement were imposed, the system would be open loop and subject to instability. It is not clear whether or not the IRC will have direct unimpeded access to internal audit, investor lawsuits, client complaint summaries, external auditors and fund compliance officers in the performance of its duties. Unimpeded access to such resources would be useful to the IRC in proactively identifying any manager actions or inactions that involve a conflict- of- interest and/or to validate that a recommendation and/or approval decision has been effectively implemented. Perhaps the Instrument could add more specificity – the Instrument should consider adding this thought in a Commentary so that IRC's have a strong database upon which to base their decisions.

There is a requirement that members must be "independent ", qualified and subject to continuing education. A requirement should be added [a para 3.8 (d)] that an IRC member couldn't retain his/her membership if they are subject to regulatory or criminal sanctions. IRC members should be required to sign confidentiality agreements and disclose if they have a relationship with a competing manager. The document also points out that the limited role would restrict the legal liability and financial exposure faced by committee members if

investors suffer losses. We have no major issue with this as long as the fundamental right of investors to seek redress through the courts is maintained.

We support the proposal requiring IRC members to perform a self-evaluation, at least once annually, concerning the effectiveness and structure of the committee and its members. However, we believe that the CSA should consider ways in which it can provide more specific, actionable guidance that fund boards can use when performing a self-assessment. Namely, the CSA should specify the factors and criteria that a board member should use when making such an evaluation.

A number of best practices have developed in the U.S. including the Morningstar governance rating criteria that could be adapted to the Canadian marketplace. One idea is that each IRC member prepares a list of goals, expectations, or benchmarks against which their performance is assessed. We also strongly urge the CSA to consider requiring public disclosure of committee self-assessments. In any event, we would add a bullet to para 4.2 item 3. Commentary – the results of the committee activities. It is essential to assess performance in measurable terms, not just activity. As former GE CEO Jack Welch said, "What gets measured gets done".

Another area that is problematic is just how many IRCs a member can serve on and still be considered effective and "independent". An IRC member should have a duty of care to the specific investors whose money is at risk in a particular fund(s). It is not inconceivable that IRCs will find themselves in conflict when they serve too many funds or where they serve funds (including different classes or series) whose interests may diverge. The cross-subsidization of funds is a real concern and well-publicized academic studies have revealed that such a conflict exists

As regards the number of funds that an IRC can manage we refer to some thinking by fund analysis and research firm Morningstar (U.S.). They understand that it is difficult, if not impossible, to set a limit on the number of funds that a board member can effectively oversee. That said, they recommend that the SEC should consider requiring board members overseeing more than 30 funds to explain how they are able to uphold the fiduciary duty owed to shareholders in their self-assessments. This explanation should include an approximation of how much time the board member allots to reviewing the operations of each fund under his/her oversight. While a 30-fund disclosure threshold will strike some as arbitrary, Morningstar's experience suggest it is a reasonable limit considering the depth and breadth of directors' responsibilities. The 30-fund limit is applicable to funds operating under tougher SEC governance rules so that the Canadian IRC's could

have a higher limit given their limited role. The idea however of some sort of upper limit requiring an explanation if exceeded strikes us as one way to deal with the challenge by forcing IRC members to think about their governance /oversight capacity.

In addition to review by the IRC, inter-fund trades will be subject to specific enforceable conditions that address concerns relating to pricing and transparency in the capital markets. We understand that inter-fund stock transfers will not be subject to a commission fee chargeable to either selling or buying fund other than the nominal *print* cost. With this understanding, the controls appear adequate. Nevertheless, we draw attention to the practice of "opposite trades", where stock purchases by low-fee funds are used to support the portfolios of the high-fee funds. This phenomenon has been reported in several academic studies.

Under the Proposed Rule, certain changes which currently require an investor vote per NI 81-102 would now be referable to the IRC who could decide on the matter absent a unit holder vote. Advance notice of a change would replace the ability of an investor to vote, thus removing one of the very few mutual fund investor rights. Since a change of auditor is an infrequent event (and sometimes a reason for suspicion), we do not see why the right to select the auditor or change in auditor is being delegated to the IRC. Indeed, we feel it is a Best Practice to have fund auditors at arms length from those of the manager or its parent. This is not often the situation today and, disappointingly, it is not a requirement of securities legislation governing investment funds.

Mergers can affect the “commercial bargain” and are most often driven by the manager’s desire to eliminate funds that fail to generate a satisfactory level of fees. Currently, section 5.6 of NI 81-102 provides some guidance and defines certain requirements (Such requirements include that a reasonable person would consider the continuing fund to have fundamentally similar investment objectives, valuation procedures and fee structure as the terminating fund). Far from being innocuous, fund mergers can and often do result in very unhappy investors. This can be because of:

1. manager change
2. an investment style change
3. a fee increase
4. a capital gains tax liability (not always disclosed)
5. a loss of tax-loss carryforwards by the merged fund (rarely disclosed)
6. significant professional and other fees are charged to the merged funds
7. an adverse impact on DSC penalty fee schedules or

8. an increase in <u>total</u> fees and expenses (not just the management fee).

We feel that these impacts are fundamental changes and deserve a vote by unit-holders unless none of the eight conditions exist. If the existing language is retained and the IRC approves a merger, then as a minimum all redemption fees should be waived for a 30-day period following the merger. More generally, we feel that any IRC decision which is harmful to investors or modifies the original reasons for investing in the fund (the "commercial bargain") should entitle investors to freely exit the fund, especially if they lose their right to vote on the change.

Under the new rules Part 6, the IRC may issue Standing Instructions (SI) to codify a pattern of decisions. The concern here is that conflict-of-interest situations will be codified and thus no longer reviewed by the IRC, para 5.4 (3) notwithstanding. In effect, these Standard Instructions would act as a legitimate vehicle for exemption from compliance with securities laws. We argue that if law prohibits an action or activity, the IRC should not have the authority to over-ride the law or worse become an SRO unto itself. In any event, all current applicable SI's (full text) should be posted on the manager's website or be made available to investors upon request for transparency and be summarily disclosed in the IRC annual report (para 4.4). As regards the 5.4 Commentary 2., we would suggest adding a bullet - assessed the manager's internal control practices and degree of compliance.

If a transaction proceeds under Part 6 of proposed NI 81-107 or Part 4 of NI 81-102 in breach of a condition imposed by either the applicable section or by the IRC in connection with a Standing Instruction (or its approval), the Commentary to section 4.5 makes it clear that the CSA will consider the transaction to have breached securities legislation. What is disturbing here is that different IRC's may attach different conditions to SI's so that different managers could treat an identical issue differently. In one case a manager may be in breach of securities law, while in another the manager would not for an identical issue. If a manager establishes multiple IRC's (as is permitted in Para 3.1 Commentary 1.) there could even be inconsistent SI's within the complex. The CSA should clarify how this *by-design* unfairness can be managed and regulated.

As a practical matter, how could a committee member argue that a "hot" IPO should not be purchased from an affiliated company especially if competitor funds have no corresponding constraints? It will be virtually impossible to challenge the manager in these cases, yet the fundamental reasons the prohibitions exist is because of demonstrated track record of prior problems. A fiduciary should not put itself in a position where its interests conflict with its fiduciary duties. Except

perhaps for the most unusual of circumstances, the IRC should not in our view be permitted to approve transactions prohibited by securities laws and certainly not be allowed to institutionalize them via Standing Instructions.

A March 2005 study by Kenmar of regulatory exemptions found that regulatory relief almost always resulted in a reduction of investor protection. We suspect the situation would deteriorate further if decisions were moved down the decision chain to IRC's from Provincial regulators. As a perhaps extreme view of how unfettered allowance of prohibitions could unfold, the reviewers are referred to a book by Adam Harmes. Harmes, Adam, "Unseen Power: How Mutual Funds Threaten the Political and Economic Wealth of Nations ", Stoddart, 2002

Appendix I provides some ideas on a decision filter regarding conflicts-of-interest that could form part of a Companion Policy/ Interpretation Bulletin. Appendix II provides some scenarios that could play out unless some of the recommended changes are introduced.

Some Other Issues

The Instrument does not grant the right to the IRC to terminate a portfolio manager even if he/she demonstrates gross incompetence consistently underperforms the benchmark or peers, consistently fails to follow the fund's publicly stated investment policy or charges excessive fees. This is one of the most important aspects of fund governance/conflicts. As an interim measure, such a shortcoming is not wholly unacceptable but we would request that the Instrument language permit removal if an advisor or sub-advisor breaches securities laws, performs acts of fraud, fails to adhere to Prospectus/AIF disclosures, routinely acts counter to unit holder best interests or fails to follow the decisions of the IRC.

We assume that independent fairness opinions will be required and made available to the IRC when proxy shares are voted if the sponsor or a related party has or is seeking a business relationship with a Corporation say for a lucrative pension fund management contract, investment banking opportunity or banking relationship.

How will the serious market-timing issues that the OSC has shown abused long-term investors be addressed? The CSA has not yet implemented appropriate regulations to curtail this practice and should do so now. Even the current prospectus disclosure can be considered a potential conflict as in most cases a frequent trading fee *may or may not* be imposed strictly at the fund Companies' sole discretion. Again, we suggest the Instrument's language make it clear in 3.9

and 4.1 that the IRC may act pre-emptively and proactively to address actual or potential conflict-of-interest issues and not depend solely on manager referrals for decisions.

"Inefficiency ", intended or not, can camouflage a conflict-of-interest. For example, one issue that may be hurting unit-holders is currency translation in international funds. If a bank-owned fund, will there be a requirement to disclose the precise method for dealing with foreign exchange to ensure that the international or global fund receives a fair deal? (Are currencies converted in bulk across funds in the complex? at what rate? is there a commission charge levied? In the case of credit cards for instance, Euros are first converted to U.S. dollars and then to Cdn. Dollars and a 2.5 % fee is added on top of that). Under NI81-107, as proposed, IRC's will not be allowed to probe this type of potential conflict-of-interest issue unless it is referred to them by the manager, an unlikely event. When the extra fees are paid to a related party will managers consider it a conflict-of-interest situation? Current disclosures in annual reports/ financial statements generally do not adequately address these concerns.

As another specific example where the Instrument could be more definitive, we note that on May 31, 2005 Citigroup Inc. agreed to pay U.S.$208 million ($128 million in disgorgement and $80 million penalties), to settle fraud charges brought by the SEC against two of the company's units, related to the creation and operation of an affiliated transfer agent (TA) that has served the Smith Barney family of mutual funds since 1999. In a nutshell, a scam was developed to defraud the funds by overcharging for transfer agent fees and giving the rebates to an affiliate and keep the details away from the governance board. The transfer agent receives a fee paid out of the fund's assets, i.e. out of the pocket of fund investors.

In all, the firm garnered nearly U.S.$93 million in pure profit from the skimming operation (the fees appear to have had a whopping 90% profit margin), plus $17 million in other guaranteed revenue. Indeed, NI81-107 should identify related party service contracts as a major source of conflicts-of-interest in a para 5.2 (1) (d). We also believe that where an IRC has approved a related party service contract that the fees for that service be broken out as a separate line item on fund financial statements of operations (if over say $10,000). The intent here is to stimulate competition and negotiation so that service contracts are awarded to the lowest, responsible, responsive suppliers, thus reducing fund expenses. We believe these expenses are at least equal in import and impact as the three elements

(inter-fund trades, related issuer transactions and purchases of securities underwritten by a related underwriter) identified by NI81-107.

Another point is loans to or from related parties. Will this be part of the IRC oversight? We believe the current language suggests this. It may not be inappropriate to add specificity. In the past, some have suggested that cost allocations to funds is at the sole discretion of the manager. In fact, the management fee bundles a myriad of expenses under this single line item in the Statement of Fund Operations so there is little public disclosure. It is not clear from the language whether or not IRC's e expected to play a role in this area despite the fact that fees and fund returns are zero-sum .As cost allocations are such an important and sensitive factor, the Instrument should provide more robust guidance here.

IRC Compensation is another issue. We would not be able to support any compensation scheme that provides IRC members compensation in the form of company stock or options. Indeed, we'd like the Instrument to speak definitively to this issue. If compensation were in the form of fund units or shares we'd expect that insider trading regulations and disclosure/confidentiality requirements would cover the IRC members.

Will investor protection be achieved if there is no oversight on advertising, marketing programs, fund churning/switching or the use of celebrity shills to lure investors into inappropriate, unsuitable investments? In a very real sense these practices create unwarranted fund sales (and management fees) and commissions and thus it could be argued demonstrate a conflict between the managers' interests to increase AUM and the best interests of investors. As we understand it these practices would not fall under the purview of the IRC because their charter is limited to protecting existing investors not potential investors. Increased CSA and MFDA enforcement of salespersons and dealer practices should minimize the level of financial assault.

There are many more issues besides conflict-of-interest that adversely impact investors. Front running for example can and has hurt investors by creating an artificial demand for a stock purchased by fund employees at an earlier lower price. Abusive sales practices, sales contests and biased compensation grids are other examples. It appears these practices will continue to be under CSA compliance reviews and surveillance and not captured by the provisions of NI81-107. We assume also that the CSA is not prepared at this time to require a registration system of fund managers although we would highly recommend such a system.

What mechanisms will be in place to prevent and detect closet indexing, which causes investors to pay for professional management but achieve index-like performance? It likely won't even come up as a conflict-of-interest topic unless the definition of conflict-of-interest is enhanced. Is excessive portfolio trading a conflict of interest if it rewards affiliated broker firms high commissions (and penalizes the fund with high trading expenses) or is it merely a portfolio managers unencumbered right? Appropriate language in NI81-107 that increases the understanding and scope of the IRC's areas of influence will prevent many problems downstream. We realize this will require a combination of explicits and principles. The 1969 Canadian Committee Report rejected relying solely on a principles-based approach to regulating conflicts-of-interest. It opted for the combination of principles and rules that is reflected, for example, in the current provisions of Part XX1 of the Securities Act (Ontario).

Auditors are especially well positioned to provide guidance on weak internal controls and systems and spot problems. NI81-107 proposes to remove the fundamental right of investors to vote on a change of auditor. Will the fund be permitted to employ the same auditor as the fund sponsor or parent? Hopefully not, but no regulatory guidance is provided. What will be the accountabilities of trustees of the mutual fund trust? Will following the decisions of the IRC protect the fund Company/trustees from civil and criminal legal action? Regulatory exemptions by provincial regulators/CSA do offer a limited degree of protection but we expect that IRC decisions will not and they will not be consistent across fund complexes.

Will the IRC be accountable to ensure that systems are in place to protect the privacy and security of unit holder personal information and the information is not used for unintended and undisclosed purposes? NI81-107 suggests that they will not. Again, there is an oblique conflict-of-interest here where the manager consciously chooses to spend less on security and privacy systems thus exposing investors to greater financial risk and identity theft. In the case of bank-owned funds, personal data might be shared with related parties such as custodians or even with the parent bank. As a suggestion, a specific requirement for privacy protection, a major concern of investors, could be added to NI81-102 as part of the omnibus changes.

What legal or other actions will a fund be expected to take if a parent or related party has unduly caused undue losses for the fund? This could happen say if a "hot " IPO is purchased from a related brokerage that it is subsequently discovered to

contain a material Prospectus misrepresentation. Would inaction to claim recovery of losses be considered a conflict-of-interest requiring a referral to the IRC? Would inaction to file for a damage claim under a successful class action result in a referral? We understand that it is the intent of the Instrument that *inaction* is within the scope of the IRC but it is far from clear to us and may be unclear to managers and IRC's applying the provisions of NI81-107.We suggest some Commentary in this area would be helpful.

It is good there is a requirement that a report will be prepared annually, wherein the IRC will be required to disclose the operations of the Committee and that the report must be posted on the manager's website and be available to unit-holders on request. We would like to see language here that the location of the posting be prominent and readily searchable. We also feel that it should be referenced in the firm's annual financial statements to draw attention to its availability. The report should specifically include summary text on Standing Instructions and a general overview of how the IRC is functioning. The financial statements should also have a separate line item presenting the gross cost of the IRC's operation and a NOTE explaining the methodology employed to allocate costs to specific funds.

We add parenthetically, that we expect the IRC's to be subject to effective regulatory oversight if investor confidence and trust in mutual funds is to be restored and maintained. We raise this point because it was the lack of effective regulatory oversight that gave rise to multi-billions of dollars of time arbitrage in dozens of mutual funds in 20 fund companies over a period of 4 years. To this day, there has not been a report explaining how and why regulators failed to detect the massive investor abuse occurring under their noses.

And perhaps most importantly, if committee members themselves uncover costly wrongdoings due to a conflict-of-interest how will the offenders be punished and investors compensated for the losses? Will a system of arbitration be established to deal with cases of alleged investor exploitation? We note that the IRC will be permitted to meet separately with regulators or law enforcement in the event of serious malfeasance even if not related to conflicts-of-interest. This is certainly a welcome provision.

Finally, we anticipate the CSA will monitor IRC Charters and IRC effectiveness and to take on a commitment to provide a public report say after 2 full years of operations. The report would address IRC effectiveness as to investor protection, issues discovered including market impact, affect on investors and planned corrective measures.

Response to specific questions

The following is our view on specific questions raised in the request for comment. Again, we want to emphasize that any comment does not condone the new approach to governance. The restraints amount to nothing more than rearranging the deck chairs on the Titanic. They are the mere mechanics of a fundamentally flawed approach.

01. Do you think this Instrument should apply either more broadly or more narrowly?
We believe the mandate must apply more broadly since the boundaries of conflict-of-interest are not always sharply defined and the threats to investors go well beyond conflicts-of-interest. Furthermore, history shows that the investment fund industry is rife with the potential for abuse and has lost a degree of investor trust resulting from recent well-publicized scandals. Nothing short of a board with real authority to implement change can be assumed to contribute to the necessary level of protection. This would have to be supported with useful regulations and robust, timely regulatory surveillance and no-nonsense enforcement. We agree with the inclusion of LSIF's in the scope of NI81-107 Rev 2 where conflicts-of-interest (and valuation issues) have already exhibited themselves to the dismay of investors. We would add Seg funds and hedge funds as well.

02. Do you agree with including smaller investment funds in the Instrument? Are there alternatives?
All mutual funds offered to the retail public should have a mechanism to prevent investor abuse. A small fund or complex would appear to be one with less than $100 M in AUM. We could accept an independent (independent to the parent) external auditor with a suitable audit mandate as an alternative to an IRC if a CSA-acceptable Compliance Plan has been prepared.

03. Do you feel that the drafting of exemptive provisions captures the conflict-of-interest exemptions granted to date?
We have been critical of a number of regulatory exemptions that have been granted by the CSA. We believe that a prohibition is a prohibition and that an IRC should not be able to over-ride them because of (a) the added risk without a corresponding degree of return, and (b) adverse affects on capital market integrity and efficiency

04. Are the key governance practices a good approach?

We are not uncomfortable with this approach.

05. Is the approach to the liability of IRC members fair?
The Davies Ward Phillips & Vineberg approach seems balanced and logical if the scope of the IRC can be described and the definition of conflict-of-interest is sufficiently robust.

06. Is the approach to the " commercial bargain" reasonable?

We request the CSA to reconsider removing the right to approve the choice of auditor as explained in several portions in this submission. Additionally, auditors should be required to pronounce on the integrity of the financial statements and internal controls to prevent abuse, not merely to confirm that they conform to Canadian standard accounting practice. This most certainly would have highlighted the market timing shenanigans years earlier.

Certain major changes can impact performance e.g. change in currency hedging policy, a change involving a merger between funds. Investors should be totally and unconditionally free of any account closing, transfer to a third party, switch or early redemption fees if the manager of the fund is changed or the fund is embroiled in any major securities law breaches. This issue arose a few years back when AGF lost Brandes Investment as an advisor, which was the primary original motivator for investors to put their money in the funds.

07. What is the cost burden on smaller investment funds?
We could go along with a reduced IRC count, say 2 members for complexes with AUM's less than $100 M.

08. Are you satisfied with the cost-benefit analysis that has been done to date as described in both the CSA notice, and in the CSA notice published on January 4, 2004 when NI 81-107 was published for comment the first time?

We regard the investor protecting provisions as basic, minimal and long overdue. Other jurisdictions have imposed more severe rules and have kept costs competitive, and in fact cheaper than most Canadian mutual funds .The recent mutual fund timing scandal cost unit-holders hundreds of millions of dollars and the Crocus LSIF will no doubt add to the misery of investment fund investors. We therefore regard the question of the accuracy of the cost-benefit analysis as redundant. Investors need this protection and should be willing to pay the modest expense for it.

Unintended Consequences of Laissez-Faire

NI81-107 would not specifically remove the self-dealing prohibitions but it allows the IRC to waive them in specific circumstances or even generally via a Standing Instruction. This will lead to more conflicts-of-interest and troubles for unit-holders. Perhaps a more perilous aspect of the elimination of these prohibitions is the impact on the small Canadian capital market. The fund industry is now so large *it is* the market. Should bank and insurance mergers take place, the concentration of share ownership in Canada will be in the hands of a very few institutions. Work-arounds of the prohibitions as permitted in the Instrument (and existing exemption orders) could seriously add significant market distortions that will further hurt the investing public, and not just mutual fund investors. For example, if an investment firm were floating a new issue of a bond, stock or income trust, under NI 81-102 section 4.1(l), a related fund manager would have to wait 60 days before being able to invest.

With the new rules in place, Canadian investors might be hurt in several ways if the IRC endorses a buy decision:

- the availability of a ready market for an IPO may cause a decision to price the IPO higher than would otherwise be the case thus adversely impacting market integrity

- the availability of a ready market for an IPO can be used to fill a gap in an under subscribed IPO, earning fees for investment bankers but adversely impacting mutual fund investors

- it encourages further erosion of the mythical "ethical walls" between mutual funds and their broker affiliates - these are the same type of walls that supposedly existed between analysts and related investment bankers that caused Nortel, Corel, YBM Magnex, and Bre-X and a host of other stock disasters to take place

- the affiliated mutual fund can be used to artificially prop up a weak IPO share price to prevent it from tanking too shortly after distribution

- a related party broker may allocate an unfair number of shares to a related party mutual fund thus distorting capital market integrity

- more often than not waiting 60 days allows the markets to establish a more rational price for a security; buying early may prove expensive for the fund as IPO's typically are priced at the highest possible market price that will sell " ...But my experience is that you can buy nine out of ten new issues at a lower price a year or two later. Companies usually go public only when they can get a high price at outset, unless they are badly in need of quick money for one reason or another ..."
  Source: S.A. Jarislowsky, The Investment ZOO, Transcontinental Books, 2005 pg 78

- Conversely, "HOT " IPOs can be used to artificially *turbo boost* short-term fund returns to increase sales; retail investors always chase returns. The resulting sales would create not only artificial market activity but clearly will attract more investors and management fees in select funds for the manager. The IRC would also have to deal with the nasty allocation problem as between funds thus adding to complexity and costs for unit-holders.

- if it turns out that the IPO was based on material misrepresentations, under the proposed rules it is highly unlikely the affiliated fund would participate in litigation or class actions to recover losses from the related dealer on behalf of unit-holders

- the trading activity with affiliated broker(s) will artificially boost earnings of the parent bank and increase its share price

For these reasons we therefore recommend that no exemption whatsoever be permitted in a class of securities underwritten by a related entity and that the existing prohibitions be inviolate. Ref 5.2 (c).

Another rule, which could be subverted by the IRC, that forbids investment funds to own parent Company shares can lead to real issues when it comes to share voting when the prohibition is removed. The fund may vote its shares consistent with the parent's wishes in support of an anti-takeover bid, or to prop up its own share price. If self-dealing is watered down, it's clear that a fund could unduly vote its large block of shares to support a position the investment banking arm is supporting thus impacting market pricing. Such cases may actually be in the best short-term interests of the fund but the impact on Canadian Capital markets could be substantial. No doubt a large spectrum of possible market distortions will be opened up as tens of millions of dollars become available by multi-billion dollar funds governed only by untested principles/committees and an ologopolistic

Canadian financial services industry. The IRC will be unable to prevent this as illustrated by Appendix II, Scenario 8. We understand that NI81-106 requires proxy share voting disclosure but worry if it will be too little, too late. We recommend again that NI81-107 keep approval of prohibited actions outside the scope of the IRC.

Other investor protection Issues

Not all of the improvements needed to improve mutual fund investor protection come from industry participants. Parenthetically we add that the following minimum investor protections should be provided by the CSA:

- mandatory improved financial statements including a better breakdown of fund costs (e.g. distribution costs, governance costs, unit brokerage expenses as % of average assets)
- re-institution of mandatory delivery of Annual reports/financial statements to investors. The negative option system is keeping this important information from small retail investors.
- the <u>quantitative</u> disclosure in prospectuses of price breakpoints or discounts (reduced sales charges and/or reduced MER's)
- the ready availability for purchase in Canada of U.S.-based mutual funds covered by SEC regulations
- the mandatory inclusion of a risk in all prospectus disclosures entitled: "Governance Risk". This risk is associated with the limited scope of IRC's and their unproven effectiveness
- increased IDA (a Self Regulatory Organization under CSA supervision) arbitration limits from $100,000 to $350,000
- the regulatory requirement for fund companies to publish their Code of Proper Business Conduct and make it available to the public upon request
- the regulatory requirement for fund companies to prohibit frequent trading which could be defined as a 90 day hold period (except for cases of personal financial emergency and the basic rights of withdrawal/recission)
- the regulatory requirement for fund companies to establish written ethics policies and programs that would include personnel training, annual certifications and hotlines and the requirement that any investigation, special audit, forensic or analytic resources necessary to protect investors against conflicts-of-interest be chargeable to the fund Company and that this cost not be an allowable cost to be subsumed in the management fee allocations
- a commitment that all CSA members will incorporate Investor Advisory boards into their structures along the lines of those in the UK and Australia

- the passing of Whistleblower laws that would protect Truthtellers (many tips on conflicted practices have come from fund employees including those that allowed Elliot Spitzer to proceed with his prosecutions of market timing U.S. mutual funds)
- a requirement that independent auditors be mandated to routinely pass opinion on internal controls. The fund's auditors should be different for the auditors of the fund Company or its parent since the end clients are different in each case. Since the mutual fund pays the audit fees, unit-holders are in fact the client not the fund Company
- amend various Provincial Limitations Acts to extend limitation periods
- require fund financial statements to flag, say by asterisk, any holdings acquired under a conflict-of-interest by either the fund sponsor or its affiliates
- ADD the following prohibitions:
  - prohibit soft dollar transactions or severely constrain their use and require better disclosure in AIF's
  - prohibit allocating shelf-space expenses to a fund or require full disclosure and tighter constraints
  - prohibit allocating any marketing or other payouts to dealers, advisors or distributors to a fund's assets or include quantitative isolable disclosure such as U.S. 12(b) 1 disclosure
  - prohibit revenue sharing arrangements
  - prohibit hedge funds from purchasing mutual funds
  - prohibit shorting as an investment strategy for a mutual fund (some regulatory exemptions are already on the books)
  - prohibit the diversion of DSC early redemption fees to the fund sponsor instead of the fund which incurred the original cost, albeit indirectly

IRC accountability is predicated on an investors' knowledge that the IRC represents their best interests. However, based on anecdotal evidence, it appears that many investors are unaware of the existence, let alone the effectiveness, of IRC's. By bringing more visibility to the fund's IRC members and alerting investors to their role in protecting investor interests, the balance of power may begin to shift from the fund management company executives, where it now resides, to the investors, where it belongs. To remedy this situation, we suggest that the CSA require each fund prospectus to begin with an explanation of the fund's structure, such as the following:

"When you buy shares in a mutual fund, you become an owner of fund units. As an owner, you have certain rights and protections; chief among them is an Independent Review Committee (IRC), whose role is to represent your interests. If

you have comments or concerns about your investment, you may direct them to the IRC in the following ways...."
We strongly believe that the Instrument in its final form should require contact information criteria in some manner.

Conclusion

Properly run, mutual funds are invaluable investment vehicles for small investors. GIC-refugee investors are typically not sophisticated and thus need and deserve full regulatory protection. Their financial health and well-being depends on it. NI 81-107 provides some protections but frankly it is too little and well past due. As written, it provides the absolute minimum level of investor protection and governance.

In summary, our main reasons for suggesting further improvements are:

- there is no convincing rationale for not implementing a more robust governance structure at this time. Recent SEC regulatory changes have implemented a wide range of regulatory changes designed to improve protection for fund investors. Canadian mutual fund investors will have significantly less protection than their U.S. NAFTA partner counterparts.
- there is no requirement for a Compliance Plan
- previous documented studies including the highly regarded Stromberg reports, the 2000 Erlichman Report, the 2003 OSC Five Year Review Committee report and the 2004 CARP/SIPA report on Mutual Funds have recommended more robust investor protecting structures have been unduly discounted, deferred or ignored
- undisclosed level of commitment to increased regulatory monitoring and enforcement. Bank mergers, fund industry consolidation, vertical integration, acquisition of dealers and the increasing number of publicly traded fund companies suggest an unprecedented concentration of the Canadian marketplace and even greater conflict-of-interest potential. This powerful force must be countered by anticipatory regulatory protections including dramatically enhanced fund governance and regulatory enforcement. Investors were less than delighted when it was disclosed that the OSC would prematurely end the mutual fund market timing probe, that no fines, or profit disgorgements would be imposed on the five market timing fund factories and that no companies or individuals would be held accountable for robbing investors of returns. Furthermore, the 15

other fund companies that engaged in market timing were never prosecuted or even publicly identified.

- Hedge funds are not included despite the fact significant issues prevail and the IDA's May, 2005 Report called on Commissions to step up to the plate
- The side-stepping and potentially wildly inconsistent application of time proven NI81-102 prohibitions via the IRC and its Standard Instructions
- Increased potential for significant Canadian capital market distortion, inefficiency and instability

There is a need for a basic common baseline standard for IRC's from the CSA that investors can expect or rely upon to be reasonably assured of the integrity of an investment fund as an appropriate vehicle to which to entrust their hard earned savings. Leaving too much leeway may lead to tremendous differences in approach and undue increased investor risks. This is especially important given that there is no Canadian equivalent of Morningstar's U.S. governance rating system for mutual funds. Such an independent analytical service that evaluates and compares mutual funds in respect of their governance standards and their impact on performance would be of assistance to investment fund investors. But it is unlikely to develop any time soon in the relatively small and concentrated Canadian market.

A weak governance structure is in fact not in the best long-term interests of the mutual fund industry. Stricter fund governance rules will benefit our capital markets in strengthening their integrity and making them safer and more transparent. Otherwise, other competitive better-regulated products will steal market share possibly to foreign issuers. In fact, after all the reforms, U.S. based mutual funds will be cheaper and better governed than their Canadian counterparts. We believe explicit and clear regulations, diligently enforced; protecting investors is in the best interests of Canada. A side benefit would be improved corporate governance generally in Canada as well as better protection against organized crime, fraudsters and terrorist organizations.

APPENDIX I - Tests for a conflict of interest

The definition of a conflict of interest as related to the IRC's duties is defined in.1.3 (1) and (2). This definition could benefit from greater definitization since it cuts to the heart of the matter and bounds the scope of IRC operations. If a principles based approach is deemed preferable then we'd like to see the following plain language in the Commentary or a separate Companion Policy/Instrument Interpretation Bulletin:
" A conflict–of–interest occurs whenever the best interests of the fund is subordinated to the interests of the manager, another fund in the complex, a party related to the manager or when any party is given undisclosed preferred treatment over other unit-holders"

We note that in the case of the market timing abuses that even when exposed, no fund company admitted or denied wrongdoing, all claimed that market timing was not explicitly illegal as if it were a defense and not a single prevailing IRC member or fund governor was removed from office. The OSC imposed no fines or sanctions, and no profit disgorgement or rule changes. This is another reason for our focus on specificity and tougher regulatory monitoring, enforcement and penalties.

A conflict of interest is sometimes easy to spot, but often it is an evasive parametric. Here are some suggested generic tests that have successfully been used to highlight or spot potential conflicts and might be suitable for inclusion in the National Instrument as guidelines:

1) when there is a certain gain for the manager and there is an uncertain gain or lesser gain/increased risk for the fund
2) when it requires cunning thought and careful wordsmithing to categorize it as not in conflict
3) when the manager is reluctant to provide full disclosure and rationale for the action or decision e.g. cost allocation to funds
4) when no predefined criteria or quantitative formulation exists to determine that the decision is win-win
5) when those making the determination are compensated in whole or in part for the success of anything other than the entity being protected against conflict of interest
6) where there are no defined penalties or sanctions when a conflict-of-interest is enacted or discovered
7) when a decision is made that favors the manager and there is no evidence that other alternatives were considered

8) when the manager's performance is consistently sub-par and no corrective actions are taken
9) when a decision is made that favors the manager when no decision would have been more appropriate for the entity
10) when the manager has positioned the situation that leaves no choice but to proceed with the conflicted act or transaction
11) when the manager's gain is more than that of the fund
12) when the manager is unwilling to sign an annual ethics certification form
13) when the conflicted act is annunciated as a necessary "one time" event
14) when costs are allocated to the fund that do not assist the entity in meeting its objectives and offer no benefit to the fund
15) when costs are incurred by the entity without documentary evidence of intense competition and negotiation
16) when you hear the words "everybody does it"

As we see it, the Investment Review Committee will have to apply these tests to such thorny items as:

- management fees vs. growth in AUM,
- soft dollar trading (such trading involves the fund paying higher expenses than normal in exchange for "free" research and other undisclosed and possibly other benefits that do not accrue to the fund),
- the allocation of sales, commission and distribution costs to a specific fund,
- the non- allocation on DSC early redemption revenue to the fund,
- directed trading (the use of brokerage/incentive fees paid to brokers and dealers to promote selected sponsor funds),
- the purchase of IPO stocks, income trusts or bonds from a related party,
- the purchase of shares of the parent company or affiliated companies,
- the selection by the fund to exclusively utilize related party organizations as custodians or brokers without competition or price negotiation.
- Vulnerability of the fund to abuse e.g. defective valuation processes
- Insider trading of fund units
- Proxy share voting and disclosure
- Fund mergers and termination
- *Inaction* resulting from a conflicted position or inattention e.g. *not* voting for a parent board resolution such as option re-pricing that could harm shareholders or failing to participate in class actions against related parties or filing claims resulting from successful class actions in general

A few examples will illustrate our concerns. How will it be determined if a merger of 2 funds is in the best interests of unit-holders without a vote? This will be difficult since different investors have different motives for investing in the funds, some tax driven. Will the committee be allowed to waive deferred sales charges when such mergers occur (or when the portfolio manager is unilaterally changed or voluntarily resigns or the fund is unilaterally terminated)? How should the IRC respond if the new MER is greater than the weighted average MER of the merged funds? Another example: Will the MER remain the same if a fund is closed to new investment? -it shouldn't since the fund is not incurring sales or marketing expenses or sales commissions. This is a clear conflict-of interest that unduly reduces unit holder returns while maintaining an unduly high MER including expenses for functions not provided or needed.

APPENDIX II: NI81-107 Conflict resolution scenarios

The scenarios described below are realistic. As can be seen, the arguments for a conflicted decision are alluring, while the ability to provide solid counterarguments is not as easy as one might believe. There is a fine line between sharp business practices and a breach of fiduciary duties.

Scenario No. 1 - conflicted IPO

Fund company: I have a situation to discuss.
IRC: Tell me about it.
Fund company: Our brokerage affiliate has a "hot" income trust IPO we'd like to buy for the fund. There is a conflict here in that our affiliate will earn some fees but this trust is good quality and we'd miss out on some fine returns. And because it's a related party we'll be getting an outsized allocation of shares. Besides our competitors have no restrictions, so all we're doing is leveling the playing field. Remember too, under the old system we routinely got OSC exemption orders for this sort of thing so it must be OK.
IRC: Sounds logical to me-go ahead. By the way, can you get me some of the IPO allocation, it's oversubscribed and hard to get?

Scenario No. 2 - voting right/choice of auditor

Fund manager: We're about to change our external auditor. Our parent corporation is switching and we can get economies of scale.
IRC: But shouldn't the auditor of the fund be independent from the parent? After all, its fund investors that need reassurance not common stock investors of your parent.
Fund factory: There's no regulatory requirement for auditor independence, the fund will save money and besides the auditors haven't reported any issues in the last decade.
IRC: I'm still not convinced
Fund manager: This is permitted as long as the IRC approves the change.
IRC: Approved

Scenario No. 3 - allocation of proceeds

IRC: Can you tell me why DSC early redemption fees are credited to the fund? Why do they go to the fund sponsor since it's the fund, which originally financed the 5 % sales commission paid to the dealer/planner?

Fund manager: No, that's not right. We write the cheque to the dealer so if there is an early redemption we want our money back .The OSC has always accepted this.
IRC: OK, but the management fees charged to the fund covers these expenses so the investors should have the money returned if there's an early redemption.
Fund company: We don't agree, but in any event, this isn't really a conflict -of-interest issue as defined in the rules.

Scenario No. 4 - conflicted proxy share voting

IRC: Why are you voting shares for management? This is a mismanaged company that has abused shareholders for years?
Fund company: Listen Jim, the management has committed to improve corporate governance and replace their VP of sales. We own a lot of stock in this company and if we unseat the current board the stock price will fall, actually hurting our fund in the short-term. Besides, we're trying to get their pension business, which means we can allocate less overhead cost to the fund in the future and reduce fees. And, we'll disclose how we voted on our website.
IRC: I see your point. Sounds like WIN-WIN. Our conflict-of-interest system is so good; we should list it as a core strength and get the marketing folks on it.

Scenario No. 5 - conflicted supplier selection

Fund manager: We want to renew our annual contract with our custodian and transfer agent, both affiliated companies. Their fees are competitive in our opinion and we're very happy with the services provided.
IRC: How do I know they're competitive? Have we asked for bids? Are we overpaying? Have we negotiated prices? Have we included robust performance and quality criteria in the services subcontract?
Fund manager: Were talking a custodian here. Our information systems are linked with the affiliate. Any transition to another supplier would be costly and disruptive. Custodial expenses are not a big cost item anyway. In any event, NI81-107 does not require your prior approval on this matter, we disclose our service provider relationships and I don't think it's a conflict-of –interest.
IRC: That's a convincing argument although I've heard of serious problems in the U.S. in this area.

Scenario No. 6 - payment of trailer commissions

IRC: I don't get it. We keep on paying 0.5% trailer fees out of fund assets but we don't know if the advisory services are of good quality or are in fact even being

provided. Shouldn't we be checking to see that investors are getting their money's worth?
Fund company: We might call them service or trailer fees but they really are a form of commission to keep investors with our funds. All of our competitors do the same thing. It's standard industry practice.
IRC: This just isn't right. You haven't even once polled investors to see if they're happy with the service. Besides, you're paying fees to discount brokers who aren't even allowed to offer advice.
Fund company: Let me be frank. This has got nothing to do with a conflict-of - interest. It's an accounting issue and our auditors have signed off on it. We disclose what we have to in the Prospectus.
IRC: Just thought I'd bring it up. No need to report under the provisions of NI81-107.

Scenario No. 7 - conflicted level of trading

IRC: I'd like to speak to you regarding the excessive portfolio turnover in our equity funds. With a near 200% portfolio turnover ratio we're incurring high brokerage commissions and tax liabilities for our investors. Much of the commissions are going to a related Company.
Fund company: This has nothing to do with your mandate. Also, we're trying to maximize pre-tax returns not after-tax returns.
IRC: We advertise that our funds are long-term investments and we barely hold our stocks for six months. The marketing materials hail buy-and-hold and that's exactly what the portfolio managers aren't doing. The big gainer here is your related brokerage firm.
Fund company: Our portfolio managers need to trade along the lines they see appropriate at any given point in time. It's nothing to do with a conflict-of-interest. Sure, our sister businesses get some hefty commissions but more than half of our brokerage transactions are not with related parties and we practice best execution. Plus, we always disclose related-party payments in the Annual report. I should add that we use soft dollars to acquire first-rate research. We get it a lot cheaper than if we paid for it directly plus we get some other goodies.
IRC: Don't soft dollars distort accounting, cost the fund more and lead to significant potential for abuse?
Fund company: Like I said before this is not a conflict-of-interest issue. The IRC shouldn't try to second-guess our investment professionals. We're in full compliance with securities laws and our auditors don't have any issues with our actions. In any event, if any investors don't like the way we run the fund they can always redeem their units and invest their money elsewhere. Everything we've discussed is off the record you understand?

IRC: If it's OK with the CSA and our auditors, I'm comfortable. I agree that it's not really a clear conflict-of interest issue and so no decision is required from the IRC.

Scenario No. 8 - conflicted voting of parent shares

Manager: We support the proposals of our parent bank and intend to vote the shares in all funds in support of management
IRC: Why is this good for the fund?
Manager: Our stock pickers say it will help boost the shares of our parent and hence the performance of the fund. It's WIN-WIN
IRC: Approved

As can be seen, conflict-of-interest resolution can be successfully debated, defended and reconciled. After a period of time, a number of standard waivers, concessions and practices become acceptable and part of entrenched policy based on precedent i.e. Standing Instructions. Over time, very little in the way of conflict-of-interest would exist in the minds of the fund managers and the Independent Review Committees. The inevitable result would be unduly reduced returns for investors.
This is why we believe prohibitions should remain prohibitions and that the definition of conflict- of- interest should be as precise as possible so that the manager, IRC and investors clearly understand the scope of the IRC influence and authority.