



Memorandum

To Susan Silma
Rhonda Goldberg
Ontario Securities Commission

From Carol Hansell

Date [July 15, 2006](#)

Subject **Proposed National Instrument 81-107**

Proposed National Instrument 81-107 (the "Proposed Instrument") contemplates the establishment by the manager (the "Manager") of an investment fund (a "Fund") of an independent review committee (the "IRC"). The IRC's mandate will be to review conflicts of interest of the Manager in respect of the Fund and other matters. The IRC must be composed of individuals who are independent of the Manager and the Fund for the purposes of the Proposed Instrument. The members of the IRC could be existing directors or advisory board members of the Fund, if they meet the required standard of independence. The IRC will be responsible, among other things, for reviewing conflict issues required to be presented to it by the Manager and approving or making recommendations in regard to such matters. The IRC may assume a broader mandate if it so agrees with the Manager.

You have asked for our view on the liability to which a member of the IRC (an "IRC Member") may be exposed under the Proposed Instrument relative to the liability to which a member of a board of directors of a corporation (a "Corporate Director") governed by a statute such as the *Canada Business Corporations Act* (the "CBCA") and similar provincial statutes would be exposed.

We have concluded that an IRC Member's exposure to liability in connection with the duties mandated in the Proposed Instrument is limited, when compared with the exposure to liability of a Corporate Director. In addition, the protection available to an IRC Member under the Proposed Instrument with respect to his or her discharge of those duties is no less than that available to a Corporate Director.

Responsibilities of the IRC

The responsibilities of the IRC are set out in Part 4 of the Proposed Instrument. Sections 4.3 to 4.6 set out certain reporting and record-keeping requirements. Sections 4.1 and 4.2 set out the more substantive aspects of the IRC's responsibilities. These responsibilities include providing the manager with a recommendation or approval for a

proposed action that involves, or that a reasonable person would consider involves, a conflict of interest for the manager, and to undertake regular assessments:

4.1 Review matters referred by manager

- (1) The independent review committee must review and provide its decision under section 5.2 or under section 5.3 to the manager on a conflict of interest matter that the manager refers to the independent review committee for review.
- (2) The independent review committee must perform any other functions as required by securities legislation.
- (3) The independent review committee has the authority to choose whether to deliberate and decide on a matter referred to in subsection (1) and (2) in the absence of the manager, any representative of the manager and any entity related to the manager.
- (4) Despite subsection (3), an independent review committee must hold at least one meeting annually at which the manager, any representative of the manager or any entity related to the manager are not in attendance.
- (5) The independent review committee has no power, authority or responsibility for the operation of the investment fund or the manager except as provided in this section.

4.2 Regular assessments

- (1) At least annually, the independent review committee must review and assess the adequacy and effectiveness of
 - (a) the manager's written policies and procedures under section 2.2;
 - (b) any standing instructions it has provided to the manager under section 5.4; and
 - (c) the manager's and the investment fund's compliance with any conditions imposed by the independent review committee in a recommendation or approval it has provided to the manager; and
 - (d) any subcommittee to which the independent review committee has delegated, under paragraph 3.11(1)(d), any of its functions.
- (2) At least annually, the independent review committee must review and assess
 - (a) the independence of its members; and
 - (b) the compensation of its members.
- (3) At least annually, the independent review committee must review and assess its effectiveness as a committee, as well as the effectiveness and contribution of each of its members.
- (4) The review by the independent review committee required under subsection (3) must include a consideration of
 - (a) the independent review committee's written charter referred to in section 3.6;
 - (b) the competencies and knowledge each member is expected to bring to the independent review committee;
 - (c) the level of complexity of the issues reasonably expected to be raised by members in connection with the matters under review by the independent review committee; and
 - (d) the ability of each member to contribute the necessary time required to serve effectively on the independent review committee.

In contrast, a corporate board of directors has very broad responsibilities for all aspects of the corporation's business and affairs. For example, the CBCA provides:

Subject to any unanimous shareholder agreement, the directors shall manage or supervise the management of the business and affairs of a corporation.

The liability to which Corporate Directors are subject results in part from the fact that they have overall responsibility for the management of the business and affairs of the corporation. The same is, of course, not true of IRC Members. It is the Manager that is responsible for the management of the Fund. The IRC has responsibility to review and provide either a recommendation or approval on certain very specific matters. The IRC is in no way the "directing mind" of the Fund, as a board of directors is of a corporation. Accordingly, there is a much more restricted range of matters for which the IRC Members could be held to be accountable solely as a result of performing their responsibilities as IRC Members as prescribed in the Proposed Instrument. Of course, if the IRC agrees with Manager to accept additional responsibilities, the members of the IRC may be exposed to additional liabilities arising from those responsibilities. In addition, if IRC Members are also directors or trustees of the Fund, they will have more wide-reaching duties to the Fund in that other capacity.

We note that Section 5.2(1) of the Proposed Instrument prohibits the manager from proceeding with certain transactions (including inter-fund trading, purchases of and holdings in securities of related issuers and purchases of securities underwritten by an entity related to the manager) without the approval of the IRC. However, the IRC cannot compel the manager to take any particular action. In addition, Section 5.2(2) sets out the determinations the IRC must first make in order to provide its approval with respect to those transactions. The fact of there being only specified transactions which require IRC approval and the codification of the steps the IRC must take to provide that approval serves to further limit the liability of an IRC Member, as compared with a Corporate Director. The board of directors of a corporate entity must itself decide (subject to certain statutory requirements) which decisions must be brought to the board and what steps the board must take in order to reach an independent and informed decision.

Standard of Care

The standard of care that the IRC Members must meet in carrying out their responsibilities is set out in section 3.9 of the Proposed Instrument:

- (1) Every member of an independent review committee, in exercising his or her powers and discharging his or her duties related to the investment fund, and, for greater certainty, not to any other person, as a member of the independent review committee must
 - (a) act honestly and in good faith, with a view to the best interests of the investment fund; and
 - (b) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

. . .

This language is based on the provisions of the CBCA and similar corporate statutes. Section 3.9(1)(a) is often referred to as the fiduciary duty. Section 3.9(1)(b) is often referred to as the duty of care.

In our view, it is likely that section 3.9(1)(a) would be interpreted in the way the parallel provision in the corporate statutes is interpreted. That is, an IRC Member would have a fiduciary duty to the Fund, but not to the individual unitholders of the Fund, or to any other stakeholders (such as creditors). The fact of the Fund being structured as trust would not alter this analysis in any material way. This structuring difference alone would not create a direct duty between the IRC Members and the unitholders (who are the beneficiaries of the trust).

Section 3.9(1) varies from the provisions of the corporate statutes in that it refers to the duties of an IRC Member "related to the investment fund and, for greater certainty, not to any other person". This addresses the issue raised by the Supreme Court of Canada in the *Peoples v. Wise* decision. In that decision, the Court noted that a director's duty of care is not owed exclusively to the corporation and that others (such as creditors) could complain that they had suffered damage as a result of a director's failure to act in accordance with that duty. While it is not yet clear how that aspect of the Court's decision will be interpreted, the inclusion of the additional language in section 3.9(1) may provide additional protection for IRC Members. This would be supported by Commentary 3 to section 3.9(1), which states that it is not the intention of the CSA to create a duty of care on the part of the IRC to any other person under paragraph (1)(b).

Due Diligence

Section 3.9 of the Proposed Instrument also provides a due diligence defence for IRC Members:

...

- (3) A member of the independent review committee does not breach paragraph (1)(b), if the member exercised the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, including reliance in good faith on
 - (a) a report or certification represented as full and true to the independent review committee by the manager or an entity related to the manager; or
 - (b) a report of a person whose profession lends credibility to a statement made by the person.
- (4) A member of the independent review committee has complied with his or her duties under subsection (1)(a) if the member has relied in good faith on
 - (a) a report or certification represented as full and true to the independent review committee by the manager or an entity related to the manager; or
 - (b) a report of a person whose profession lends credibility to a statement made by the professional person.

This provision parallels a similar defence for directors in the CBCA and other corporate statutes. It does not limit the due diligence defences available to IRC Members, but does validate the reliance, in good faith, on the materials referenced. In our view, a court would look to this defence in determining whether the IRC Members had discharged the duties assigned to them in the Proposed Instrument in accordance with the duties established in the Proposed Instrument.

Tort Liability

We do not expect that the exposure of IRC Members to liability in tort would be significantly different from the exposure of Corporate Directors in tort. In order for an individual member of a board to be held personally liable, he or she must have taken some action that is outside of his or her role as a member of the board. Provided that directors have not engaged in fraud, deceit or dishonesty and did not purport to act beyond their authority, then they will not be held personally liable "...unless it can be shown that their actions are themselves tortious or exhibit a separate identity or interest from that of the company so as to make the act or conduct complained of their own".¹ It is unlikely that IRC Members who do nothing other than provide their recommendation or approval for certain matters would be held vicariously liable for the negligence of the Fund with respect to those matters. As previously noted, it is the Manager that is responsible for the management of the Fund.

However, directors (as well as officers and employees) remain responsible for their own tortious conduct causing physical injury, property damage or a nuisance, even when they were acting pursuant to their duties to the corporation.² It is possible, for example, for a director who made misrepresentations directly to investors to be held liable for damages suffered by an investor who relied on those misrepresentations. The same would be true of an IRC Member who made misrepresentations directly to investors in the Fund.

The Proposed Instrument provides:

4.4 Reporting to securityholders

- (1) An independent review committee must prepare, for each financial year of the investment fund and no later than the date the investment fund files its annual financial statements, a report to securityholders of the investment fund that describes the independent review committee and its activities for the financial year and includes:

...

¹ *Montreal Trust v. ScotiaMcLeod* 23 B.L.R. (2d) 165 (Ont. C.A.) at 176.

² This principle is subject to what is known as the exception in *Said v. Butt*. This exception relates to inducement for breach of contract.

The fact that the Proposed Instrument requires the IRC to provide a report directly to unitholders could give rise to liability for the IRC Members if they were negligent in preparing the report.

Indemnities

Section 3.14 of the Proposed Instrument provides an indemnity for IRC Members which parallels the provisions in the CBCA and other corporate statutes permitting or requiring a corporation to indemnify directors and officers (with the exception that it does not require court approval where an action is commenced by the Fund). It will be open to IRC Members to negotiate contractual indemnities with the Manager and Fund that will provide the broadest protection permitted by this provision.

We would be pleased to discuss this with you in greater detail.

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