On January 9, 2004, the Canadian securities administrators released for comment proposed National Instrument 81-107 Independent Review Committee for Mutual Funds. This long-awaited mutual fund governance rule would require a manager of one or more publicly offered mutual funds to establish an independent review committee and refer to it, for its recommendations, any matter in which the fund manager has a conflict of interest.

Improving mutual fund governance has been a priority for the Canadian securities regulators for several years, although exactly what this would entail and how it would be implemented has been a moving target. National Instrument 81-107 represents the latest—and most concrete—step in an on-going evolutionary process that began in the 1990s with the debate over the need for independent boards for mutual funds and increased regulatory standards for fund managers.

We believe that mutual fund governance must be tailored not only to the unique relationships among a fund manager, its mutual funds and the investors in those mutual funds, but also to the structures inherent in the Canadian industry. Improved mutual fund governance cannot be achieved simply by grafting corporate governance principles onto the way that Canadian mutual funds have been managed for over 50 years. In this Investment Funds Advisory we describe the form of fund governance contemplated by the Canadian regulators in the draft rules and highlight the significant impact these rules, if adopted, would have. We also point out areas where we think changes are necessary in order to achieve a better fit with the realities of the Canadian fund industry.

Fund governance continues to evolve

NI 81-107 represents a modest step towards the proposed five-pillared framework for regulating mutual funds and their managers suggested by the securities regulators’ March 2002 Concept Proposal1 and, if adopted, will change mutual fund regulation in important ways.

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**Status of the Proposed Framework**

<table>
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<tr>
<th>Pillar 1 Minimum standards for fund managers and registration</th>
<th>&gt; Not addressed in NI 81-107. Due to other initiatives, including the Fair Dealing Model described in a Concept Proposal of the Ontario Securities Commission released in January 2004 and the uniform securities legislation (USL) released in December 2003, the regulators have chosen not to move forward at this time with this portion of the Concept Proposal.</th>
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<tr>
<td>Pillar 2 Fund governance and independent oversight</td>
<td>&gt; NI 81-107 creates a mandatory mutual fund governance scheme for most public mutual funds.</td>
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</table>
| Pillar 3 Product regulation and conflicts regime | > **Product regulation:** Not addressed in NI 81-107. The major portion of the rules contained in NI 81-102 would be unaffected by NI 81-107. The regulators say they propose to undertake a review of NI 81-102 as a "next phase" project.  

Conflicts regime: Part XXI [Insider trading and self-dealing] of the Securities Act (Ontario) and the equivalent parts of other Canadian provincial securities legislation would be amended to the extent that the legislation overlaps with the scheme set out in NI 81-107. Amendments have not yet been published for comment. Although we note that the draft USL (released for comment in December 2003) appears to have been drafted to accommodate the regime proposed in NI 81-107—for example, the draft legislation does not contain equivalent sections to Part XXI of the Securities Act (Ontario), being the insider trading and self-dealing legislation applicable to mutual funds (and other investment funds). Similarly, Part 4 of NI 81-102 would be amended, also to the extent that it overlaps with NI 81-107. |
| Pillar 4 Disclosure and investor rights | > **Disclosure:** NI 81-101 and proposed NI 81-106 would be unaffected by NI 81-107, except that they may be amended to incorporate the disclosure provisions presently contained in NI 81-107.  

**Investor Rights:** Part 5 Fundamental Changes of NI 81-102 would be replaced (in part, at least) by section 3.2 of NI 81-107. Amendments to NI 81-102 have not yet been published for comment. |
| Pillar 5 Enhanced regulatory presence | > As with the Concept Proposal, NI 81-107 is not intended to address how the regulators’ administer regulation. |
National Instrument 81-107 only applies to public mutual funds

NI 81-107 would apply to most publicly offered mutual funds (as defined in securities regulation) and their managers, but would not apply to labour sponsored investment funds, mutual funds that are listed on stock exchanges or mutual funds that are “not governed” by NI 81-102. The regulators do not give any guidance about their expectations for governance of these excluded mutual funds, nor do they propose any form of governance for other types of investment funds (whether public or sold in the exempt market), such as closed end funds, hedge funds, pooled funds and scholarship plans. Because the corporate governance rules adopted earlier this year by the Ontario Securities Commission and the other Canadian regulators and the corporate governance disclosure rule and policy published for comment, expressly do not apply to investment funds, governance of investment funds not covered by NI 81-107 will be essentially unregulated. We question whether this regulatory gap is desirable. Not only does it create an uneven playing field, but it suggests that governance of public investment funds is not as important as corporate and mutual fund governance.

Fund manager must establish an IRC

NI 81-107 would require each mutual fund to have an independent review committee (IRC) consisting of at least three individuals, all of whom must be independent. One IRC could act in that capacity for all the mutual funds that are managed by a fund manager and the regulators suggest that two or more managers could, in effect, share one IRC for all the mutual funds managed by those managers. We expect that most fund managers, from a practical perspective if NI 81-107 is adopted, will establish a committee of individuals to act as the IRC for all their mutual funds. This committee would be given authority to carry out the responsibilities contemplated in NI 81-107, through amendments to the mutual fund’s constating documents and would operate independently of management and the trustee, in the case of mutual funds structured as trusts, and the board of directors, in the case of mutual funds that are corporations.

Appointment of IRC members

A fund manager would be required to appoint the first members of the IRC within the deadlines established by NI 81-107—generally one year after NI 81-107 comes into force. Thereafter, only the IRC could fill any vacancies. In the rare event that all members of an IRC cease to be members at the same time (which would occur under NI 81-107 if the fund manager changed or all members resigned at the same time), NI 81-107 would require the fund manager to “forthwith” appoint new members.

Recognizing the perception that IRC members might be biased in favour of a fund manager that appoints them, NI 81-107 would require that members be appointed with staggered terms. Terms of office must be at least 2 years and not more than 5 years in length, although members could be reappointed (by the IRC) after their term expired.

An IRC member would continue to be a member of that IRC until his or her term ended or he or she resigned or was otherwise disqualified from continuing as a member of the IRC. Members could also be removed by a vote of a majority of the other members of an IRC. In addition, members of an IRC for a mutual fund would automatically cease to be members when the mutual fund terminated or the manager of the mutual fund changed. The regulators explain that an IRC member must be free to perform his or her duties without fear of being dismissed or removed by the fund manager due to unpopular recommendations. Therefore, a fund manager may only seek to remove a member by calling a meeting of the security holders of the mutual fund to ask them to vote on the removal.

Although we agree that the appointment and removal mechanisms set out in NI 81-107 are both appropriate and practical, we believe that IRC members also should automatically cease to be members if the control of a fund manager changes (we comment below on how NI 81-107 appears not to address changes in control of fund managers).

In our view, the fund manager will be in the best position to recruit and appoint the first members of the IRC. Once the
IRCs are operational, we expect that the remaining members will be in a position to appoint replacements to fill vacancies. The regulators acknowledge that the fund manager may assist in the recruitment process, although the final decision-making must be left with the IRC.

All IRC members must be independent

All members of an IRC must be independent within the meaning of NI 81-107. An individual will not be independent if he or she has a direct or indirect material relationship with the manager, the mutual fund or an entity related to the manager. An entity related to the manager includes major shareholders of the manager and all affiliates, associates or subsidiaries of such persons and of the manager. A direct or indirect material relationship is defined as any relationship that a reasonable person would consider might interfere with the exercise of the member’s independent judgment regarding conflicts of interest facing the manager.

The regulators provide guidance on the range of material relationships that would taint an individual’s independence. Generally, a cooling off period of at least three years is required. This means that an individual would be considered independent if his or her "material relationship" with the fund manager, mutual fund or entity related to the manager ended at least three years before their proposed appointment to an IRC.

Significantly, the board of directors or committee of the board of directors of the fund manager would not be considered independent for the purposes of NI 81-107, even if that board or committee were made up of otherwise independent individuals. This is because those individuals are directors of the fund manager and have a duty to act in the best interests of the fund manager and the shareholders of that fund manager. If these individuals were to also act as the IRC, the regulators consider that these individuals would have divided loyalties, which potentially could cloud their independent judgment.

The regulators, however, propose that the independent members of the board of a registered trust company that acts as trustee for a mutual fund could act as the IRC for that mutual fund, even when the registered trust company is related to the fund manager, provided they have no other material relationships and are considered independent directors for the purposes of the trust and loan corporations legislation.

We believe that, for transition purposes, individuals that today act as independent directors on the board of a fund manager should be permitted to become the first members of the IRC for the mutual funds managed by that fund manager. So long as these individuals have no other material relationships, within the meaning of NI 81-107, we believe, from a pragmatic perspective, that these individuals, who often have been appointed to the fund manager’s board to act as an additional check and balance, should not be tainted by this association and barred from acting as members of the IRC.

We also believe that some of the regulators’ examples of "material relationships" provided in the commentary to NI 81-107 that they say would prohibit an individual from being appointed to an IRC have too broad a scope. In our view, many otherwise appropriate and independent-thinking individuals would be barred from being appointed to an IRC due to so-called "material relationships" that, in reality would have little or no bearing on their independence.

The IRC will have a defined role and function

Recommendations about conflicts

If adopted, NI 81-107 will establish a role for the IRC that will be unique to Canada. Unlike the U.S. model of fund boards, an IRC will not have the general responsibility to oversee or supervise the management of the mutual funds carried out by the fund manager. Instead, the IRC will have a role only once the fund manager has referred a matter to it.

NI 81-107 retains the central principle of Canadian mutual fund regulation—the fund manager has the responsibility and accountability for managing its mutual funds in accordance with its fiduciary responsibilities. A fund manager must identify a range of matters relating to conflicts of
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interest that it must then refer to the IRC for its recommendations before taking any action in connection with those matters. The IRC must consider and “provide impartial judgement” on the matters referred to it, including the actions proposed by the manager concerning such matters, and make recommendations to the manager as to whether the manager’s proposed actions would achieve a fair and reasonable result for the mutual fund. The fund manager will consider those recommendations when deciding what action to take in the matter, but ultimately will make a decision having regard to its fiduciary responsibilities to the mutual funds. However, if a fund manager does not follow the IRC’s recommendations, NI 81-107 will require the manager to disclose in the funds’ continuous disclosure documents why it did not adopt them.

NI 81-107 will require a fund manager to refer matters to the IRC when its business and commercial interests could reasonably be said to conflict with its duty to act in the best interests of the mutual fund. NI 81-107 sets a broad, open-ended test for when a fund manager must refer a matter. Although we suggest technical corrections to this test be made to achieve the regulators’ intentions, it appears designed to require a fund manager to refer a matter to an IRC, if the fund manager cannot objectively determine whether it is making a decision or taking an action in connection with that matter that is in the best interests of the mutual fund, because of its other commercial or business interests. The regulators give guidance on the range of conflict matters they expect to be referred to the IRC and note that the list is not exhaustive and they do not expect every mutual fund manager to experience these conflicts. The range of conflicts is far-reaching and goes beyond the related party transactions and self-dealing provisions that are currently prohibited or restricted in securities legislation and regulation.

We believe that this all-important test for referrals to an IRC must be definitive and not open to different interpretations. Although simply stated, the test as written in NI 81-107, may be very difficult to apply to individual circumstances and could give rise to unintended results. It also is not clear how the test would apply where portfolio management or other management services are outsourced to third parties, particularly where these third parties are not related to the manager. Given the stated objective of the Canadian regulators—to improve fund governance and introduce independent judgement in areas where the fund manager is conflicted—we believe that objective would be met if NI 81-107 set out a prescribed list of material conflict matters that the fund manager must refer to the IRC for its recommendations. We believe that this list would be relatively easy to define and would provide much needed certainty to both fund managers and to the members of an IRC.

Recommendations about proposed changes to the mutual funds

NI 81-107 also would require a fund manager to refer to the IRC proposals to change its mutual funds in prescribed fundamental ways, on the theory that the fund manager is conflicted in proposing these changes. With minor wording changes, the matters that must be referred to the IRC for its recommendations are the same matters that currently must be approved by the security holders of a mutual fund as required by Part 5 of NI 81-102—including proposals to increase fees or expenses or change the fundamental investment objectives of a mutual fund.

Under NI 81-107, if the fund manager wished to increase fees or change the fundamental investment objective of a mutual fund after it received the IRC’s recommendations, the fund manager still must obtain security holder approval of the proposed change before implementing it. The fund manager could implement all other fundamental changes, including changes in auditor and fund mergers, after it has considered the IRC’s recommendations and given security holders 60 days advance notice of the change. Both the meeting materials (in respect of the matters where a vote is required) and the advance security holder notice must contain a summary of the recommendations of the IRC. For all fundamental changes, security holders must be given the right to transfer free of charge to another mutual fund managed by the fund manager.
We have some technical issues with the proposed rules in this area. For example, the rules do not acknowledge the current exemptions that allow no load funds to increase fees provided notice is given and non-affiliated parties to increase their fees and expenses charged to a mutual fund. NI 81-107 also does not appear to address changes in the shareholders of a fund manager that result in a change in the control of the fund manager. It is not clear whether the regulators intend for "changes in control" of a fund manager to be caught by their use of the phrase "change in manager". Given the logistical problems that have resulted from the current requirement to give 60 days advance notice of a change in control, we recommend that NI 81-107 deal with changes in control in a more streamlined way. Further, we urge the regulators to re-consider the regulatory approvals currently required to be obtained before certain fundamental changes, such as changes in manager, changes in control of manager and fund mergers, can be made—NI 81-107 does not purport to change these requirements.

Inter-fund trading

NI 81-107 would allow a mutual fund to trade securities to a related mutual fund, including a related pooled fund, provided certain requirements are met. Inter-fund trading is currently prohibited by securities legislation and has long been on the wish-list of the Canadian mutual fund industry.

Under NI 81-107, the IRC must review all proposed inter-fund trades—the draft rules don’t clearly state whether this must be done on a case-by-case basis or whether the fund manager can refer a general inter-fund trading policy to the IRC for its recommendations—and recommend what would be fair and reasonable for each mutual fund involved in the proposed inter-fund trades. In addition, inter-fund trades would only be allowed if certain defined market integrity and transparency rules are followed in respect of each trade, including printing through a member of an exchange, compliance with foreign transparency rules for foreign securities and reporting trades to registered dealers.

We view the proposed rules in this area to be overly prescriptive and arguably unnecessary. Given the potential for conflicts of interest, we understand the regulators’ proposal for IRC review of inter-fund trading. However, we believe that a fund manager should be able to develop an inter-fund trading policy for its mutual funds, which would include its policy on fair pricing and allocation of securities among the mutual funds. This inter-fund trading policy would then be considered by the IRC. Also, given other securities regulation designed to achieve transparency of the securities held by portfolio managers, on an aggregate basis, we question the need for the purported market integrity rules concerning individual inter-fund trades. We view these rules as potentially negating any benefit to security holders from the reduced transaction costs that would otherwise result from inter-fund trading.

Responsibilities of an IRC

NI 81-107 would require an IRC to consider and "provide impartial judgement” on a matter that a fund manager refers to it. The IRC will be required to recommend what action the manager should take to achieve a fair and reasonable result for the mutual fund. The IRC must carry out its responsibilities having regard to the standard of care set out in NI 81-107—to act honestly and in good faith, in the best interests of the mutual fund and to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. Under NI 81-107, an IRC member will not contravene this standard if he or she exercises reasonable judgment based on information available at the time he or she considered the matter.

We expect that individuals considering whether to act as an IRC member will be concerned about their potential liability. The regulators have addressed this issue, in part, through defining the role for an IRC as well as each member’s standard of care. NI 81-107 also permits a fund manager to purchase insurance for the IRC members (and charge that expense to the mutual funds) and allows a mutual fund to indemnify the members of an IRC. The regulators say that they considered the comments on the Concept Proposal
urging them to limit the liability of the IRC, but concluded that they do not have the authority to make rules in this area. We believe that further dialogue is necessary on the extent of the responsibilities—and potential liability—of an IRC member, in order that IRC members can understand the scope of what they will take on. We are also concerned about the practicalities of a mutual fund indemnifying IRC members, given the need to calculate net asset value on a daily basis and the difficulties we anticipate in quantifying a potential indemnity claim.

In our view, it is essential that NI 81-107 be amended to clarify the extent to which, if at all, an IRC will be expected to look into potential conflict matters that are not referred to it by the fund manager. NI 81-107, as drafted, does not appear to require the IRC to take any action, unless the fund manager refers a matter to it—given the recent events in the United States and their implications for fund boards, we expect an IRC member will want his or her responsibilities clearly stated. Similarly, better guidance is necessary on the extent of due diligence expected of IRC members on matters that are referred to it for consideration.

Responsibilities of fund managers

A fund manager will continue to be subject to its fiduciary responsibilities to its mutual funds, both at law and pursuant to securities legislation in several Canadian provinces. We expect that the standard currently in securities legislation will continue, either in legislation or in rules, although the regulators do not address this provision in NI 81-107 nor in the USL published materials. As well, it will be important that securities regulation acknowledge that a fund manager will have met its standard of care if it follows the recommendations of the IRC in respect of a conflict matter, provided the fund manager has supplied the IRC with all relevant information.

NI 81-107 requires a fund manager to send security holders reports of the IRC if the IRC asks these reports to be sent. A fund manager will also be required to organize a meeting of security holders to consider and vote on a specific matter if the IRC believes this is necessary. The regulators indicate that they believe an IRC should only require a fund manager to send information to security holders or convene a special meeting in unique circumstances, including when it has been unable to resolve a difference of opinion with the fund manager. We are concerned that an IRC will use these powers in circumstances that have not been contemplated by the regulators and believe additional guidance is necessary.

A fund manager will also be required to provide the IRC with information sufficient for it to properly carry out its responsibilities in respect of any matter that the fund manager refers to it. The fund manager must also make its senior officers available to attend meetings of the IRC as the IRC may direct, although no representatives of the fund manager can be present during IRC deliberations and decision-making.

Thinking ahead to implementation

We expect that as a practical matter it will take some time for the regulators to finalize NI 81-107, given that we believe material changes should be made to it. Assuming that NI 81-107 will be adopted within the next year or so, it is critical that the industry, including advisers to the industry, and the regulators work together to ensure a smooth transition, over time, to the new regime.

In anticipation of some form of mandatory fund governance, fund managers might begin to identify the range of potential conflict matters that would be referred to an IRC, as well as thinking about how its IRC would be structured. In establishing a new mutual fund, a fund manager will want to consider incorporating in that fund's constituting documents, sufficient flexibility to allow it to comply with any new rules, without later amendments.

Fund managers can also begin to think about the first members for its IRC. Apart from the independence requirements, NI 81-107 does not set any proficiency or educational standards for members of an IRC. We expect that fund managers will need to consider matters such as knowledge of, and experience with, the mutual fund
industry, the overall financial services industry, legal or accounting background and integrity and 
business judgment of each prospective member of an IRC.

The comment process

We intend to comment on NI 81-107 by the comment deadline of April 9, 2004. We would be 
pleased to also comment on your behalf if you ask us to. We expect to raise for the regulators’ 
consideration many of the issues we identify in this Investment Funds Advisory. We are also 
reviewing, and may comment on, the four comments raised by the British Columbia Securities 
Commission published in a separate BC-only notice on January 8, 2004 and available on the BCSC 
website at www.bcsc.bc.ca. The Ontario Securities Commission published the proposed methodology 
of its Chief Economist for carrying out a cost-benefit analysis—this proposed methodology includes a 
revised costs analysis—as well as a report on the benefits of allowing mutual funds to engage in 
previously prohibited transactions with related parties. These documents are available on the OSC 
website at www.osc.gov.on.ca and comments on them can be provided to the OSC.

We have followed closely the developments in fund governance leading up to this most recent release. 
At the invitation of the Ontario Securities Commission, John Hall and Lynn McGrade were active 
participants in the ad hoc mutual fund governance committee organized by the Ontario Securities 
Commission after the release of the Concept Proposal to help them with legal issues around 
implementing mutual fund governance. Rebecca Cowdery, the project leader on the fund governance 
proposals at the Ontario Securities Commission until July 2003, joined our Toronto office in 
November 2003. If you would like to discuss the proposed National Instrument and how it might 
apply to you, please call your regular BLG contact or any one of the lawyers in our National 
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