

# Investment Funds Bulletin

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Fasken Martineau DuMoulin LLP

## Investment Fund Governance in Canada: National Rule to come into force November 1, 2006

### Introduction

On July 28, 2006 the Canadian Securities Administrators (“CSA”) published National Instrument 81-107 *Independent Review Committee for Investment Funds* (the “Rule”) in final form. The CSA state that the Rule imposes “a minimum, consistent standard of independent oversight for all publicly offered investment funds in each of the jurisdictions represented by the CSA.” Thus, the Rule is the CSA’s first legislated step in creating an investment fund governance regime for Canada — a regime that will apply not only to conventional public open-end mutual funds, but also to many other publicly offered investment funds in Canada including closed-end funds that trade on the Toronto Stock Exchange, labour-sponsored funds, flow-through share limited partnerships and commodity pools.

Subject to the provinces and territories across Canada passing implementing regulations, the CSA expect the Rule to come into force on November 1, 2006. Within six months of November 1, 2006 (i.e. by May 1, 2007), the manager of every investment fund governed by the Rule must appoint the first members of an Independent Review Committee (“IRC”).

New investment funds governed by the Rule which are formed after May 1, 2007 will require an IRC to be in place before the fund’s public offering. By November 1, 2007: the manager and the investment funds governed by the Rule must have in place a charter for the IRC; the manager’s written policies and procedures regarding “conflict of interest matters” and other matters which securities legislation requires the manager to refer to the IRC must be prepared by the manager and reviewed by the IRC; and the manager must refer to the IRC for its review any existing “conflict of interest matters” (discussed below). On November 1, 2007, all exemptions and waivers previously granted by the CSA which deal with matters regulated by the Rule will expire, irrespective of whether they contain a sunset provision.

Fund managers may decide to comply with the Rule earlier than the dates set out above should they wish to be able to seek IRC approval to proceed with certain actions which presently are prohibited, restricted or require securityholder approval, such as inter-fund trades, investing in securities of related parties or underwritten by related parties, changing fund auditors or carrying out certain fund mergers (discussed below).

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## Background

The Rule is the result of a lengthy process. The background to the Rule is important in order to understand the context in which the Rule will operate.

The modern fund governance debate in Canada began in 1993 when Stephen Erlichman, now a senior partner of this firm, presented a paper entitled “Managing Potential Conflicts of Interest” at a mutual fund conference. After discussing various potential conflicts in the Canadian mutual fund regime and fiduciary duties of various parties in an investment fund complex, Mr. Erlichman concluded his paper by asking a simple question: “In light of the 1992 study by the United States Securities and Exchange Commission and the 25 years which have elapsed since the 1969 Mutual Funds Report, is it time to re-examine potential conflicts of interest in the mutual fund structure and the possible role of independent directors to monitor or approve such conflicts?”. In 1995, Glorianne Stromberg’s report to the CSA made recommendations with respect to many aspects of the Canadian mutual fund industry, including mutual fund governance, and subsequently fund governance was commented upon by the Investment Funds Steering Group in 1996, a Quebec Consultative Committee Report in 1997 and a report of the Standing Senate Committee on Banking, Trade and Commerce in 1998. In 1999, the CSA commissioned Stephen Erlichman to prepare a report setting out his recommendations for a mutual fund governance regime for Canada. In 2000, Mr. Erlichman’s report to the CSA entitled “Making it Mutual: Aligning the Interests of Investors and Managers - Recommendations for a Mutual Fund Governance Regime for Canada” (the “Erlichman Report”) was published by the Ontario Securities Commission in order to commence a dialogue on fund governance among the CSA and interested stakeholders. In 2002, the CSA released Concept Proposal 81-402 setting out the CSA’s vision for a renewed framework for regulating mutual funds and

their managers, which was “a very robust system of fund governance” largely based on the recommendations in the Erlichman Report. In 2004, the CSA published their 2004 Proposal, which “in response to strong industry feedback to limit the role of the governance body” narrowed the focus of the governance body to “oversight of the potential conflicts of interest that exist for fund managers in the operations of their funds” and which renamed the governance body the Independent Review Committee. In 2005, the CSA published their 2005 Proposal in which the CSA “made a number of significant changes to the 2004 Proposal to provide for a greater level of investor protection” as a result of the comments the CSA received from stakeholders, “in particular, investors and investor advocates who urged [the CSA] to give the IRC more ‘teeth’”, as well as a consequence of the CSA’s “own experience to date with the exemptive relief that we have granted from the conflict prohibitions and restrictions in securities legislation”. According to the CSA, the Rule published on July 28, 2006 has made changes to the 2005 Proposal but those changes are “not material”. Thus, the CSA state that the Rule “continues to reflect the key changes made in the 2005 Proposal” and, in particular, the IRC’s role still focuses solely on conflicts of interest.

As stated in the Erlichman Report, “there is no consensus in Canada as to whether a new mutual fund governance regime is necessary or appropriate nor, if Canada is to have a new mutual fund governance regime, what type of regime should be established”. Similarly, the CSA state in the introduction to the Rule that “throughout this initiative, we heard divergent views from stakeholders on almost every aspect of our proposals”. Accordingly, one would expect that various stakeholders in the Canadian investment funds industry will continue to have many divergent views about the Rule.

## Summary of the Rule

The major provisions in the Rule are summarized below, but the actual Rule and the CSA's published commentary thereon are much more complex than this summary. In addition to the Rule, however, common law and statutory fiduciary obligations will continue to be part of the Canadian mutual fund governance framework.

### A. The IRC

- Each investment fund must have an IRC. The IRC must have three or more members (the actual size to be determined by the manager) and each IRC member must be independent (i.e., the member must not have a material relationship with the manager, the investment fund, or an "entity related to the manager"). The manager may convert an existing governance body it may have into the IRC provided that the 100% independence requirement is satisfied. There can be a separate IRC for each investment fund or the same IRC can act for families of investment funds.
- The IRC must appoint one of its members as a Chair, who will be responsible for managing the mandate, as well as the responsibilities and functions, of the IRC.
- A decision made by the IRC requires the agreement of a majority of the IRC members.
- The IRC can choose to have the manager present at IRC meetings, but at least one IRC meeting annually, or a portion thereof, must not have the manager in attendance.
- The manager appoints each member of the first IRC. Vacancies and reappointments will be made by the IRC itself, but the IRC must consider the manager's recommendations. The term of office of an IRC member can be from one to three years, and through reappointments the maximum term of an IRC member is six years unless the manager agrees to a longer term.
- The IRC must adopt a written charter which includes its mandate, responsibilities and functions, and the policies and procedures the IRC will follow when performing its functions. In adopting the charter, the IRC must consider the manager's recommendations, if any.
- The manager and the IRC may agree that the IRC will perform functions in addition to those prescribed by the Rule and securities legislation. If additional functions are agreed upon, the Rule does not regulate those additional functions.
- The manager sets the initial compensation and expenses of the IRC. Thereafter, the IRC sets its own "reasonable compensation and proper expenses", but in so doing must consider the manager's recommendations. The compensation and expenses will be paid by the investment fund, unless the manager in its discretion decides to reimburse the investment fund for these costs and the fund's prospectus so discloses.
- The Rule sets out a standard of care for the IRC members similar to the standard of care found in corporate legislation for boards of directors. In addition, the Rule sets out the circumstances in which the IRC members are permitted to be indemnified by the investment fund and by the manager and also to have insurance coverage paid by the investment fund and by the manager.
- An IRC of more than three people has the authority to delegate functions to a subcommittee of at least three members of the IRC, but any such delegation does not absolve the IRC from responsibility for the delegated function.

- An IRC can engage independent counsel and other advisors it determines useful or necessary, but the CSA expect that the IRC will use independent advisors selectively and only to assist, rather than replace, IRC decision-making.
- Prescribed information relating to the IRC must be disclosed in a fund's prospectus and certain other public documents.

## B. IRC Functions and "Conflict of Interest Matters"

The attached decision tree, which was published as part of the Rule, succinctly sets out in visual form the review, recommendation and approval procedures with which the IRC and the manager will be involved. The following highlights certain aspects of the decision tree.

The manager is obligated to refer to the IRC for its review and either its approval or recommendation (as discussed below) a "conflict of interest matter", which is defined as (i) "a situation where a reasonable person would consider a manager, or an entity related to the manager, to have an interest that may conflict with the manager's ability to act in good faith and in the best interests of the investment fund", or (ii) "a conflict of interest or self-dealing provision listed [in an appendix to the Rule] that restricts or prohibits an investment fund, a manager or an entity related to the manager from proceeding with a proposed action". The CSA state that although managers are required "to refer all conflict of interest matters - not just those subject to prohibitions or restrictions under securities legislation - to the IRC so that an independent perspective can be brought to bear on the manager's proposed action", the CSA "do not consider it the role of the IRC to second-guess the investment or business decisions of a manager or an entity related to the manager".

The Rule deals with two types of conflicts, namely (i) structural conflicts, meaning those conflicts resulting from proposed transactions by the manager with related entities of the manager, fund or portfolio manager which are currently prohibited or restricted by securities legislation, and (ii) business or operational conflicts, meaning those conflicts relating to the operation by the manager of its funds that are not specifically regulated under securities legislation. A decision by the fund manager to engage in certain transactions giving rise to structural conflicts prohibited or restricted by securities legislation (i.e., inter-fund trades, purchases by a mutual fund of the securities of related issuers, and purchases of securities by mutual funds during the distribution period and the 60-day period thereafter where the offering is being underwritten by a related party) must, among other requirements prescribed by the Rule and National Instrument 81-102, be approved by the IRC before the transaction may proceed. The approval may be on a case-by-case basis, or in the form of a standing instruction. For any other proposed course of action that involves a conflict of interest for the manager, the IRC must provide the manager with a recommendation (rather than an approval), which the manager must consider before proceeding.

The IRC has additional obligations not set out on the attached decision tree. These obligations include the following:

- At least annually, the IRC must review and assess the adequacy and effectiveness of: the manager's written policies and procedures; any standing instructions it has provided to the manager; the manager's and the investment fund's compliance with any conditions imposed by the IRC in a recommendation or approval it has provided to the manager; and any subcommittee to which the IRC, as permitted by the Rule, has delegated any of its functions;

- At least annually, the IRC must review and assess the independence of its members and the composition of its members;
- The IRC must as soon as practicable deliver to the manager a written report of the results of an assessment under the foregoing two bulleted items;
- At least annually, the IRC must review and assess its effectiveness as a committee, as well as the effectiveness and contribution of each of its members;
- The IRC 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 that describes the IRC and its activities for the financial year and that includes various matters prescribed by the Rule;
- If the IRC is aware of an instance where the manager acted in a conflict of interest matter but did not comply with a condition imposed by securities legislation or by the IRC in its approval, the IRC must as soon as practicable notify in writing the investment fund's principal securities regulator;
- The IRC must maintain records, including: a copy of its current written charter; minutes of its meetings; copies of any materials and written reports provided to it or prepared by it; and the decisions it makes;
- The IRC and the manager must provide orientation, consisting of educational or informational programs, to enable new IRC members to understand the role of the IRC and the role of the individual IRC member.

As a result of the Rule, the manager will be able to dispense with securityholder approval for a change

in the fund's auditor or to carry out certain fund mergers, provided the IRC approves the change of auditor or fund merger and specified notice and prospectus disclosure is made.

## Conclusion

The Erlichman Report concluded by reminding the CSA that “better governance is not an end in and of itself but rather is a means to an end” and then stated that “these recommendations and whatever governance regime is implemented as a result of these recommendations should be re-evaluated in light of any future empirical evidence that is developed as to whether problems exist in the Canadian mutual fund industry, whether better fund governance leads to better fund performance and whether the governance regime is responsive to the other matters raised [in the Erlichman Report]. The purpose of the re-evaluation would be to determine whether any of these recommendations or the adopted governance regime should be altered in light of such empirical evidence and thereby establish a more effective and efficient mutual fund governance regime.” The CSA's statement accompanying the Rule is similar, saying that the “CSA expect that fund governance will evolve with time, and we anticipate that the governance framework set out in the Rule will provide a flexible platform for future regulatory reform. We are committed to reviewing the impact of the Rule following its implementation.”

In publishing the final Rule, the CSA also state that “while we remain confident that the five-pillared framework for mutual fund regulation we outlined in the Concept Proposal is a sound blueprint for change, we also understand that we cannot bring all five pillars into place overnight. The CSA remain committed to the pillars of fund regulation, some of which are already in place while others are being addressed in separate policy initiatives currently underway.”

Accordingly, the investment fund governance regime established in Canada pursuant to the Rule is expected to evolve over time. Provisions of the Rule may change as a result of experience and empirical evidence, while other rules may be adopted (such as mandatory compliance plans recommended in the Erlichman Report and currently the subject of a separate policy initiative — proposed to become National Instrument 81-108 — announced by the Ontario Securities Commission in its 2006/2007 Statement of Priorities as a response to the results of its previous probe of market timing in the Canadian mutual fund industry).

Investment fund governance is a broad and complex area. The Erlichman Report said in 2000 that fund governance “refers to having a system in place whereby decisions in a mutual fund complex are made in the best interests of the securityholders of the mutual funds rather than in the best interests of any other party”, while the introduction to the Rule quotes the similar definition of investment fund governance given in 2005 by the International Organization of Securities Commissions, namely “a framework for the organization and operation of investment funds that seeks to ensure that

investment funds are organized and operated in the interests of fund investors, and not in the interests of fund insiders”. There will be many decisions to be made in order to efficiently implement the Rule in fund organizations across Canada. Fasken Martineau DuMoulin LLP is at the forefront of fund governance and is available to assist investment fund industry stakeholders with the Rule and with all other fund governance matters.

For more information on the subject of this bulletin, please contact the author:

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## Our Investment Funds Group

*Fasken Martineau's Investment Funds Group, comprised of lawyers in our Toronto, Montreal and Vancouver offices with expertise in corporate/securities, tax, derivatives and trusts, is recognized as one of the leading investment funds legal practices in Canada. We act for public and private open-end mutual funds, closed-end funds, REITS and other investment funds, as well as labour-sponsored venture capital funds, special purpose investment vehicles and Canadian and international investment fund managers, investment advisers and dealers. We have excellent working relationships with the Canadian securities administrators and other government and private organizations involved in the investment management industry. We have been at the centre of Canada's fund governance initiatives. If the Investment Funds Group at Fasken Martineau can be of assistance to you, please contact us.*

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APPENDIX A to COMMENTARY — DECISION TREE

