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Mutual Fund Governance in Canada: Recent Lessons

In 1993 I concluded an article I wrote for an investment funds conference by asking whether it was “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”. Over five years ago the Ontario Securities Commission published “Making it Mutual: Aligning the Interests of Investors and Managers - Recommendations for a Mutual Fund Governance Regime for Canada” (the “Erllichman Report”), which is the report I was commissioned to write for the Canadian Securities Administrators (“CSA”) to assist them in formulating a mutual fund governance regime for Canada. The Erllichman Report contained numerous recommendations to establish a “made in Canada” mutual fund governance regime. Of those recommendations, to date two have come to fruition – one being my recommendation for limited liability protection for unitholders of mutual fund trusts (such legislation now has been enacted in the Provinces of Alberta, Ontario and Manitoba largely as a result of the growth of income trusts and the lobbying efforts of that constituency), and the other being my recommendation for disclosure of proxy voting guidelines of mutual funds (which now is part of the CSA’s National Instrument 81-106 – Investment Fund Continuous Disclosure). The other recommendations in the

Erllichman Report have yet to be implemented. This article refers to three recent developments in the Canadian mutual fund industry and asks if there are lessons to be learned which could provide the impetus to implement a mutual fund governance regime in Canada soon.

1. Conflicting Interests of the Manager’s Shareholders and Mutual Fund Unitholders

The November 8, 2005 editions of Canada’s two national newspapers both contained articles describing the “white knight” agreement entered into on November 7 by Industrial Alliance Insurance and Financial Services Inc. to purchase the shares of mutual fund manager Clarington Corporation for \$14.25 a share, thus trumping the unsolicited bid of \$13 per share made by CI Fund Management Inc. a week earlier. Bill Holland, the outspoken chief executive officer of CI, said he would withdraw CI’s unsolicited bid when told of the Industrial Alliance agreement, but he complained about the conflicts inherent in the decision made by the board of directors of Clarington in agreeing to have Clarington acquired by Industrial Alliance.

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One of the articles stated the following:

“...Bill Holland, CI’s chief executive officer, said Clarington’s board of directors is neglecting the best interests of the company’s retail unitholders. The aborted CI offer included a commitment to cut Clarington’s annual fund management fees [charged to the unitholders of the mutual funds managed by Clarington] by an average of 37 basis points. ...

Clarington ‘gave up tens and tens of millions of dollars worth of cost reductions for the unitholders [of the mutual funds managed by Clarington] for a buck and a quarter for shareholders [of Clarington], for an extra \$15 million,’ he said.”

The other article was even blunter:

“Still, some analysts suggested the deal is not as good for unitholders [of the mutual funds managed by Clarington] as the CI bid, which promised to lower Clarington’s management fees.

Bill Holland, CI chief executive, said Clarington’s board of directors put shareholders [of Clarington] ahead of unitholders [of the mutual funds managed by Clarington] in accepting the Industrial Alliance bid.

‘They gave up \$50 million of fee cuts [which CI announced it would make post closing for the benefit of the unitholders of the mutual funds managed by Clarington]...so they could get another \$15 million’, or \$1.25 a share, from the rival bidder.... If we just left the fees the way they were, we could have offered \$3 more a share.

He said the ‘folly’ of the situation is that Clarington does not have a separate board of governors to look after the interests of unitholders.”

I found it very interesting to read that the chief executive officer of one of Canada’s largest mutual fund managers was lamenting that an independent governance body did not exist at another mutual fund group, thus at least implicitly endorsing a role for independent governance bodies at mutual funds. Perhaps unbeknownst to Mr. Holland is that in 1993 I first asked whether some independence is needed in the mutual fund structure to monitor or approve such conflicts, and in fact the first recommendation in the Erlichman Report was that the CSA require mutual funds to have an independent governance body. In addition, the Erlichman Report specifically recognized the conflict that can exist between the interests of the shareholders of the manager, on the one hand, and the interests of the unitholders of mutual funds managed by that manager, on the other hand, and suggested a solution to this conflict. The Erlichman Report stated that there is “a potential conflict between the duty (whether statutory or at common law) of the manager to the mutual fund securityholders and the manager’s duty to its own stakeholders. It is possible that circumstances may arise in which these two duties conflict and, in the event of such conflict, the issue is which duty prevails”. The Erlichman Report then referred to recent legislation in Australia that dealt with this situation and stated that “such legislation is important because it contemplates that conflicting duties may exist and then clearly indicates that the interests of the securityholders of the mutual funds are paramount if such a conflict in fact exists, thereby relieving a person with the conflict from having to decide where his or her primary duty lies”. The Erlichman Report went on to recommend that, in addition to mandating an independent governance body for mutual funds, a conflict rule be enacted: “laws should be enacted to specify that in the event

there is a conflict between the duty of the governance body, the manager or individual directors or officers to the mutual fund securityholders and any duties to other parties, the duty to the mutual fund securityholders takes precedence". The Erlichman Report also recommended, as a measure ancillary to a legislated conflict rule, that "laws be enacted to provide to the members of the governance body the benefit of a legislated business judgment rule".

In the absence of an independent governance body at a mutual fund that could vet conflicts, and as Canada does not yet have a legislated conflict rule nor a legislated business judgment rule, are the directors of an investment fund manager placing themselves straight in the line of sight of class action lawyers when these directors make a decision that will favour one set of stakeholders over another (which, in the view of Bill Holland in the Clarington scenario, means putting the interests of the manager's shareholders ahead of the interests of the unitholders of the mutual funds managed by Clarington)? We may not find out the answer to this question in the Clarington case, since at the time of writing of this article CI had upped its takeover bid for Clarington to \$14.75 a share and as well promised \$81 million in fee savings to unitholders of the Clarington funds, thus benefiting both groups of Clarington stakeholders and thereby perhaps unintentionally removing the threat of class action litigation against the directors of Clarington who previously had agreed to the Industrial Alliance bid.

2. Missing Mutual Fund Assets

The Canadian press has been busy this year letting Canadians know about managers of various mutual funds allegedly absconding with mutual fund assets, with the mutual funds managed by Norbourg in the Province of Quebec appearing in the limelight on an all too regular basis. The Norbourg situation appears to be so serious that it has been reported

Quebec's securities regulator has taken the unprecedented step of itself launching a \$94 million lawsuit against Norbourg's founder, accusing him of taking assets which belong to the mutual funds. The Erlichman Report recognized that mutual fund assets could be misappropriated and made two recommendations which, if implemented, could reduce the potentially dire consequences for mutual fund investors: having a contingency fund for the benefit of mutual fund investors and requiring manager registration.

With respect to a contingency fund, the Erlichman Report stated the following:

"When investors purchase mutual fund securities, the risk which they have bought into is the risk that the investment performance will not be satisfactory. Investors do not, however, expect that they will lose their money because of insolvency of the mutual fund manager, fraudulent transactions or loss of limited liability as securityholders. ... In order to protect mutual fund securityholders against losses that could result from the insolvency or fraud of a mutual fund manager, a plan could be established to provide reimbursement to mutual fund securityholders similar to the reimbursement that would be available to clients of security dealers pursuant to the existing Canadian Investor Protection Fund. I believe it is important that some type of plan be adopted. Accordingly, I recommend that the CSA should encourage the development of a mutual fund investor compensation plan to protect securityholders against losses that could result from fraud or the insolvency of a mutual fund manager."

An alternative method to deal with the concern that fund assets could be misappropriated (which does not suffer from the possible problem with an

investor contingency fund of some managers subsidizing others) is to require fund managers to be registered with the securities regulators and, as a condition of registration, mandating minimum capital requirements and fidelity insurance requirements for fund managers. In this regard, the Erlichman Report referred to relevant Australian developments:

“Licensing [i.e., registration] is an effective way of imposing and monitoring the controls [for mutual fund managers]. ...Licensing will enable the regulator to screen out insolvent companies, those that do not have the required level of capital and those that do not have adequate compliance measures. Licensing provides a means of monitoring the operations of [mutual funds] and imposing any necessary changes to the [mutual fund’s] operations through licence conditions.

...A minimum capital requirement is demonstration of [a manager’s] commitment to the industry, and of its substance and credentials to perform collective investment responsibility. It also offers investors an added degree of security and a sensible fiduciary discipline on [managers] who would not want to expose their capital base.”

Accordingly, the Erlichman Report recommended that each mutual fund manager should be required to be registered with the CSA and that conditions of registration would include various requirements, including minimum capital requirements and fidelity insurance requirements. As part of the registration process, the Erlichman Report recommended that the board of directors of the fund manager should certify that it has reviewed any proposed conditions of registration and that the board believes that the manager will be able to satisfy the conditions.

3. Market Timing

In the past year, five of Canada’s largest mutual fund managers agreed to pay approximately \$200 million to settle market timing allegations. The Erlichman Report recognized that improper activities could take place in the mutual fund industry and thus recommended that, in addition to senior management trying to instil a culture of integrity into their fund organizations, there should be a requirement to have compliance plans for mutual funds, coupled with an incentive, namely a legislated due diligence defence, in order to lessen the possibility of such activities occurring. Five years ago, well before the U.S. mutual fund late trading and market timing scandal arose and before the corporate abuses in the U.S. with respect to Enron, Worldcom, Tyco and other companies were publicized, the Erlichman Report stated:

“I believe it is of paramount importance that every mutual fund complex have a culture of integrity that is fostered at the most senior levels of the organization and is inculcated throughout the organization. Although a culture of integrity can be encouraged, however, it is very difficult, if not impossible, to effectively mandate such a requirement. Accordingly, whatever the form of governance regime that results from these recommendations, I believe it is important that the manager, with the input of the governance body, prepares a compliance plan for each mutual fund.

...A compliance plan is one way of trying to assure both the securityholders of a mutual fund and the regulator that the mutual fund is being operated in the best interests of the securityholders of the mutual fund. ... In an effort to make the compliance plan workable and effective, and to create an incentive for mutual fund organizations to prepare well thought out plans, I suggest that a

compliance plan, if properly reviewed and monitored by the mutual fund's governance body, should create a due diligence defence for the governance body and for the manager of the mutual fund against claims alleging breaches of matters covered by the plan."

The Erlichman Report included a policy statement of the Australian Securities and Investments Commission which provided guidelines on how to prepare a compliance plan for an Australian mutual fund and included as an annex thereto illustrative guidance on what might be included in the compliance plan. Several of the questions asked in the annex were relevant to market timing, including the following:

"How does the responsible entity ensure that the scheme property [i.e., the mutual fund assets] is valued at regular intervals appropriate to the nature of the property? How does the responsible entity ensure that the scheme property is valued in a manner appropriate to the nature of the property?"

4. Conclusion

Notwithstanding that twelve years have passed since I first asked whether there should be some form of independent body in a mutual fund complex to monitor conflicts of interest, and more than five years have gone by since the publication of the recommendations in the Erlichman Report, Canada still does not require compliance plans for mutual funds, registration of (and minimum capital and fidelity insurance requirements for) mutual fund managers, a contingency fund for the benefit of investors in mutual funds, or independent individuals in a mutual fund complex to assist in making decisions in the best interests of mutual fund securityholders (nor, of course, does Canada have a legislated conflict rule, business judgement rule or due diligence defence). The CSA's National

Instrument 81-107 is expected to come into force sometime in 2006 (perhaps with the Province of British Columbia opting out) and that will require publicly offered investment funds to have independent review committees to focus on conflict of interest situations. After Canada's market timing problems became public and after the U.S. Securities and Exchange Commission adopted rules requiring U.S. mutual funds to have comprehensive compliance policies and procedures as well as to have a chief compliance officer who reports to the fund board of directors, the Ontario Securities Commission stated that it is considering mandating compliance programs for mutual funds. The Ontario Securities Commission also recently indicated it is considering requiring registration of mutual fund managers. There has not been any discussion, as far as I am aware, of any type of legislated conflict rule or business judgment rule to protect persons such as directors of mutual fund managers who make a decision which will benefit one group of stakeholders (such as the shareholders of a mutual fund manager) while at the same time possibly resulting in a detriment to another set of stakeholders (such as the unitholders of a mutual fund managed by the manager).

Perhaps the three developments highlighted in this article will prompt the CSA and the mutual fund industry to work together to have an effective and efficient "made in Canada" mutual fund governance regime up and running soon rather than leave it to class action litigation to shine the spotlight on these issues and be the impetus that moves the process forward. As stated in the Erlichman Report, "I suggest that trying to prevent problems ahead of time through a governance regime is a more efficient way to handle issues rather than resorting to litigation to resolve problems that may not have arisen or might have been alleviated had an effective governance regime been in existence in the first place".

Please contact the writer if you wish to discuss these issues further.

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