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EXPLANATION OF TERMS USED IN THIS REPORT

The following terms are used in this report with the following meanings unless the context otherwise requires:

"AIMR" - refers to the Association for Investment Management and Research

"Canadian Committee Report" - refers to the Report of The Canadian Committee on Mutual Funds and Investment Contracts - A Provincial and Federal Study published in 1969 by the Queen's Printer for Canada (the "Canadian Committee Report")

"central commission" - refers to the entity or the arrangement that results from the proposal outlined in Section 4 for a regulatory structure that provides centralized, coordinated, streamlined and functional regulation

"CDS" - refers to The Canadian Depository for Securities

"CDIC" - refers to the Canada Deposit Insurance Corporation

"CIPF" - refers to the Canadian Investor Protection Fund

"CICA" - refers to the Canadian Institute of Chartered Accountants

"CICA Section 5900 Reports" - refers to the accounting standards and recommendations set forth in Section 5900 of the CICA Handbook concerning the circumstances in which an auditor may rely on audit reports prepared by another auditor with respect to internal controls and procedures of a third party when the auditor determines that these controls and procedures relate to aspects of the client's internal controls and procedures

"CSA" - refers to the securities regulatory authority in each of the provinces or territories of Canada

"FASB" - refers to the Financial Standards Accounting Board in the United States

"ICI Report" - refers to the report of the Advisory Group on Personal Investing which was established in the United States in early 1994 by the Investment Company Institute to review the practices and standards governing personal investing and to make any recommendations deemed necessary or desirable in the interests of investors, which report was released on May 9, 1994

"IDA" - refers to the Investment Dealers Association of Canada

"IFIC" - refers to The Investment Funds Institute of Canada

"IOSCO" - refers to the International Organization of Securities Commissions.

"IOSCO Principles" - refers to the Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum developed by the IOSCO Working Party No. 5 on Investment Management which forms part of the Chairman's Report to the Technical Committee - September 1994

"independent board" - is used in this report to refer, in the case of an investment fund that is constituted as a corporation, to its board of directors and, in the case of an investment fund that is not constituted as a corporation, to a board of governors or an advisory committee or other entity with equivalent duties and responsibilities to those of a board of directors of a corporation, which board, in either case, is comprised of persons, a majority of whom are "unrelated persons"; the term **"unrelated persons"** is used in this definition of "independent board" to mean persons who are free of relationships and other interests which could or could reasonably be perceived to materially interfere with the exercise of judgment in the best interests of the investment fund

"Joint Regulatory Coordination Group" - refers to the joint regulatory coordination group described in Section 5.1 consisting of representatives of the Canadian banking, trust, loan, insurance, pension and securities regulators, the key function of which would be to provide a coordinating mechanism among member regulators and their global counterparts

"MD&A" - refers to the discussion and analysis by management of the operations of an investment fund that is to be included in the annual and interim reports of the investment fund as outlined in Section 17.04

"NASD" - refers to The National Association of Securities Dealers, Inc., the self-regulatory organization registered with the SEC, whose membership includes virtually every broker/dealer in the United States that does a securities business with the public

"National Policy No. 39" - refers to the national policy statement adopted by each of the CSA which consolidates and restates the policy provisions of each of the CSA with respect to investment funds

"National Policy No. 36" - refers to the national policy statement adopted by each of the CSA which provides for a simplified prospectus offering system for investment funds

"OSFI" - refers to the Office of the Superintendent of Financial Institutions

"outside directors" or "unrelated persons" - means individuals who are free of relationships and other interests which could, or could reasonably be perceived to, materially interfere with the exercise of judgment in the best interests of the corporation

"related party" - is used throughout the report with the intention that: (i) the term encompass the broadest definition that is reasonable of persons that could be considered to have an interest in or exercise influence over the actions of the "base person or entity" in question, (ii) the precise definition of the term be developed in the context of the follow-on work that arises out of this report, (iii) the term be given a broader meaning than is attributed to the concept of "related party" within the meaning of the term as used in the generally accepted accounting principles and standards of the CICA and, in particular, that it be defined to provide that an investment fund manager and its related parties would be considered to be related parties of the investment funds sponsored by the investment fund manager

"SARP Standards" - refers to CDIC's Standards of Sound Business and Financial Practices

"SEC" - refers to the United States Securities and Exchange Commission

"Securities Regulator" - refers to the central commission described in Section 4 or, if the recommendation to establish a central commission is not implemented, the CSA

"SFAS" - refers to a Statement of Financial Accounting Standards issued by the FASB

"SRO" - refers to the strong, independent, effective self-regulatory organization described in Section 9.02 that would operate on a national basis in which membership would be mandatory for everyone (regardless of their status) who is selling securities, including investment fund securities, to the public

"STAMP" - refers to the Securities Transfer Agents Medallion Program offered by The Securities Transfer Association, Inc.

"TSE" - refers to The Toronto Stock Exchange

"universal common standards" - refers to the proposal contained in Section 24.03 to develop a uniform or common set of standards with respect to the calculation and use of performance information that would be universally used

REGULATORY STRATEGIES FOR THE MID-'90s

RECOMMENDATIONS FOR REGULATING

INVESTMENT FUNDS IN CANADA

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1. OVERVIEW

1.01 The Task

In February of 1994, I was asked by the Ontario Securities Commission to undertake a review of the Canadian investment funds industry for the purpose of considering whether there is a need to make changes in how investment funds and the offering and sale of their securities are currently regulated. This request was supported by the Canadian Securities Administrators (the "CSA") and my report is being delivered to all of the CSA.
I have been asked to include in my report, recommendations as to:

- the issues to which regulators should respond;
- any changes that should be made in the current regulatory requirements;
- the role of self-regulatory organizations with respect to regulatory requirements;
- the resources that the CSA require to fulfil their role in respect of regulatory requirements;
- the realignment of the systems and procedures of the CSA for more effectlve and efficient regulation of the offering of securities of investment funds.

In considering whether there is a need for change, the CSA want to identify:

The request is outlined in the Remarks of Edward J. Waitzer, Chairman of the Ontario Securities Commission at The Investment Funds Institute of Canada, February 15, 1994 - "Looking Before We Leap - Regulating the Mutual Fund Industry" - (1994), 17 OSCB 754 - 758.

- the significant trends in the industry and what their impact will be on regulation;

- whether from a regulatory point of view there are problems affecting the investment fund industry and investors and, if so, what the problems are, where they are and how they may be remedied;

- what the "emerging issues" in the investment fund field are that should be addressed by the CSA and what the impact will be on the resources that are required by the CSA.

The main reason for the review is to be sure that regulation is keeping pace with changes in the marketplace.

Due to the constraints of time and resources, I have had to concentrate my review and recommendations on open-end investment funds that are offered for sale pursuant to a prospectus that has been filed with one or more of the CSA. Therefore, the report, unless otherwise noted, refers only to such investment funds. Despite the concentration on open-end investment funds, there are elements of the matters discussed in the report that apply to all types of investment funds regardless of what they are called. Accordingly, some of the recommendations made in the report reflect this fact.

1.02 The Process

The process has involved extensive consultation with industry participants, their advisors, the regulators and the industry organizations. This consultation has primarily involved personal interviews and meetings. In addition, I benefitted from numerous telephone conversations with people who wanted to express their views. In the course of my review, I also considered how other countries are regulating open-end investment funds to see whether there are different regulatory approaches that might be appropriate here.
Early in the process, the industry recognized that the results of the review would be largely dependent upon the quality of the industry's input into the review. As a result people made a real commitment in time and resources to participate in the review. I want to acknowledge publicly and express my thanks for the unqualified help and support that was

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It is estimated that there have been at least 125 meetings involving at least 275 people.

provided by so many during the course of the review. In particular, I would like to thank The Investment Funds Institute of Canada ("IFIC").

The review has already served as a catalyst for industry participants to focus on what is happening in the industry, what the concerns are and how they can be meaningfully addressed. There is remarkable consensus as to the issues and what should be done. Hopefully, this report will further advance the process.

1.03 The Perspective

I have approached my recommendations from the perspective that:

- what is good for the investor is good for the industry and will foster efficient, effective capital markets;
- the "industry" includes all aspects of money management;
- the foundations of the industry are integrity and trust;
- because there is frequently a lack of knowledge and a lack of bargaining power on the part of many investors, the concept of "buyer beware" cannot by itself be permitted to govern the activities that result in individuals investing their money in investment funds; there is a need, in this situation to have regard for the interests of investors by ensuring that the system operates fairly and openly;
- there is a need to increase the knowledge and awareness of investors and to ensure that investors have timely and relevant information to assist them in making their investment decisions and in monitoring the same;
- the line between selling and advising has substantially disappeared and there is a need to increase the proficiency and training of the persons dealing with the public to enable them better to serve the needs of investors;
- there is a need for better regulation rather than more regulation;
- within this environment, the regulatory strategy should be to allow competitive

forces to operate with minimal intervention.

1.04 Importance of the Investment Fund Industry

The investment fund industry is important to the Canadian economy and to the investing public. Industry participants are justifiably proud of the fact that the industry has grown to the size that it has without there being any major problems. They recognize the importance of ensuring that the public's expectations are and continue to be met in this respect. They have stressed the importance of there being the right regulatory environment, designed to support the integrity and trust upon which the industry is founded but freed of impediments such as inter-provincial barriers that make it difficult and costly for the industry to develop and function on a national basis.

Industry participants have also pointed out the potential benefits that could flow to Canada by encouraging the development of a Canadian-based investment fund service industry that has access to and is supported by the technological infrastructure necessary to provide services not only to Canadian-based operations but also to global ones. To encourage and sustain this development in Canada, they advise that there is a need for Canada to provide highly trained people and a competitive tax regime and regulatory environment.

1.05 Rapid Growth of the Investment Fund Industry

The investment fund industry in Canada has undergone phenomenal growth in the last ten years with most of the growth occurring in 1993. By way of illustration, at the end of 1982, the amount of mutual fund assets under management by members of IFIC was $4 billion. By the end of October, 1994, the amount of mutual fund assets under management by IFIC members had increased to $130.5 billion. These assets were divided among 799 mutual funds managed by 76 companies. Thirty-nine of these companies controlled less than $250 million in mutual fund assets under administration. The total number of securityholder accounts at the end of October, 1994 was 13,175,081.

All figures included in Section 1.05 are based upon information provided by The Investment Funds Institute of Canada ("IFIC") and include assets held in money market funds. IFIC advises that as of September, 1991, IFIC members represented 97% of mutual fund assets under management in Canada and that prior to that date, IFIC members represented approximately 75% - 80% of mutual fund assets under management in Canada.

This compares to $67.3 billion of mutual fund assets under management by IFIC members at the end of 1992 divided among 543 mutual funds managed by 74 companies. Thirty-eight of these companies controlled less than $250 million in mutual fund assets under administration. The total number of securityholder accounts at the end of 1992 was 5,514,245. Additional statistical information and graphs provided by IFIC are contained in Schedule One to this report.

According to a 1993 Study prepared by Investor Economics Inc., the fact that mutual funds represent only 16.8 per cent of the total investments made by individuals is indicative of the enormous growth potential that lies ahead for this industry. This observation appears to be consistent with the results of a survey conducted in August of 1993 by Marketing Solutions of Toronto, Canada that indicates that only 26 per cent of Canadian households own mutual funds, with 59 per cent of these households having acquired these assets after 1991.

1.06 Timeliness for Industry and Regulatory Review

In view of the importance of the investment fund industry to Canada and to the investing public, the rapid and extraordinary growth of the industry (most of which occurred in 1993) and the potential for further growth, industry leaders as well as regulators have recognized that it is an appropriate time to review practices, refocus on objectives and align industry interests with those of investors.

The purpose of identifying the significant trends in the industry, the problems that need to be addressed and the emerging issues that will affect the industry is to identify areas of industry vulnerability. My comments should be viewed in this context and not as criticisms of the industry or as indicative of there being any "crisis" in the industry.

My comments reflect what knowledgeable industry participants have consistently told me. The fact that they have openly discussed potential problem areas (and suggested solutions) reflects an industry that is mature enough to withstand such introspection as well

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The Next Decade: The Outlook for Retail Financial Services in Canada, a Study prepared in 1993 by Investor Economics Inc., Toronto, Canada. The information derived from this Study which is referred to or quoted in this report is used with the permission of Investor Economics Inc.

as the recognition by its leaders that the success and long-term viability of the industry is substantially due to the fact that as problems have been identified, the industry and its regulators have responded with sensible regulation. The observations of Don Phillips, the Publisher of Morningstar Mutual Funds, are as applicable in the Canadian context as they are in the American one when he observed that "[if] mutual funds are to live up to the public's heightened expectations, mutual-fund leaders will need to reclaim the industry's tradition of bold, forward-looking regulation. ... ultimately, the health of any industry is defined not by the amount of criticism it receives, but by its response to and anticipation of that criticism".

1.07 Framework for Dealing with Immediate Challenges

The major areas that present challenges (which are discussed in detail later in this report) relate to:

- distribution issues,
- conflict of interest concerns,
- the need to enhance proficiency and training for industry participants,
- the need to increase investor awareness and understanding of investment issues,
- a securities regulatory regime that is cumbersome and costly to comply with and lacks the resources to monitor compliance with its requirements,
- the lack of comparability of information about investment products, and
- a disclosure system that is ineffective in actually informing investors of material facts and that is perceived by the industry as being irrelevant to investors.

My recommendations are intended to encourage and assist the industry and its regulators in proactively addressing these areas of concern and, in doing so, to continue to meet the

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A Trust Retained, Don Phillips, Morningstar Mutual Funds, September 2, 1994.

public's expectations and merit their confidence. The framework for my recommendations is based upon proposals for:

- # Centralized, coordinated, streamlined, functional regulation

- # Strong, effective, self-regulation by the industry in respect of the management and distribution of investment funds based on:

  - ! High ethical standards

  - ! Fair practice and business conduct rules

  - ! Effective and efficient systems, controls and procedures

  - ! Pro-active and timely monitoring

- # Improved corporate governance provisions in respect of investment funds

- # Increased emphasis on educational and proficiency requirements for industry participants aimed at providing industry participants with:

  - ! better training and proficiency skills

  - ! better awareness of ethical standards, fair practice and business conduct rules

  - ! better ability to meet client needs and expectations

- # Increased emphasis on the importance of investor education aimed at improving the ability of investors to:

  - ! identify, request, review and understand the information needed to assess investment recommendations made to them
  - ! apply the information to their own situation in making

investment decisions

! identify, request and review in a meaningful manner the information needed to monitor their investments on a continuing basis and assess whether adjustments are needed

Realignment of the elements of the disclosure system aimed at:

! integrating primary and secondary disclosure requirements

! improving disclosure requirements to ensure that the information is relevant, timely and meaningful

! ensuring that disclosure is integrated and continuing

Establishment of a basis for achieving comparability of performance information about different investment products and between investment products of the same type

Establishment of a steering group to guide and oversee the follow-on work arising out of this report

1.08 Follow-On Work

The recommendations contemplate that the proposals that are outlined in the report and the other issues that are raised will be further developed by the industry and the regulators, as appropriate, before being implemented. The recommendations are intended to serve as a starting point for this work and to stimulate thinking in this context. The follow-on work may well produce other and better ideas than those that are suggested here. The suggestions for organizing the follow-on work are contained in Section 29.

2. THE ENVIRONMENT

An awareness of the strategic forces affecting the investment fund industry is needed in order to provide a context in which the issues that require a regulatory response may be considered together with the proposed response thereto. These strategic forces are outlined below. They are dealt with at some length because I believe that the regulatory strategies of the mid-'90s need to be developed with the realities of the changing marketplace in mind.

It should be noted that there was virtual unanimity among industry participants in identifying the strategic forces that are affecting the investment fund industry today. I did not find anything in the course of my review to indicate that the key strategic forces that industry participants identified were not, in fact, the key strategic forces that are affecting the industry. In addition, it should be noted that the independent study by Investor Economics Inc. that was commissioned in 1993 by IFIC and certain industry participants**,** identified the same forces. In outlining these forces, I have, with the permission of Investor Economics Inc., drawn heavily on its perceptive articulation of what these forces are and what the likely implications will be of the impact of these forces.

2.01 Strategic Forces

Economic and demographic forces, combined with the growing awareness of individual Canadians that they must take charge of providing for their own retirement, and the resulting competition that there is for the right to provide for the needs of these individuals are the key forces that have been identified as driving the investment fund industry. These are outlined below.

The Aging Population

During the last 25 years, the increase in the size of the borrower segment of the population (the 25 - 44 age group) created a demand for personal and mortgage credit and a demand for deposits and liquid-type savings instruments. The aging of the baby boomers has and is continuing to result in the needs of Canadian households changing as they focus increasingly on: (i) savings, financial assets and the accumulation of wealth in advance of retirement, (ii) the maintenance of wealth after retirement, and (iii) the transfer of wealth between generations.

Supra, note 4.

A Decline in Relative Importance of Intermediated Financial Services

The changing needs of Canadians has resulted in there being less demand for credit and this in turn has resulted in a decline in the relative importance of intermediated financial services. This decline in the relative importance of intermediated financial services is attributable in part to a decrease in the need for financial intermediaries to compete aggressively for deposits as a mechanism to fund the loans they make to others. Financial institutions, whose core business was once based upon intermediation, are adopting strategies that are aimed at: (i) retaining and building wealth-management relationships with customers, and (ii) utilizing the deposit-generating delivery structure of the financial institution. Resources previously earmarked for their intermediation business, are being dedicated to the development of fee-generating products and services. This strategic shift to value-added, fee-based services is resulting in financial institutions facing new and different competitors as well as new and different competitive and cultural challenges.

The Transfer of Risk to the Individual

Individuals are assuming more risk. This is occurring because of an increasing awareness of alternative investment instruments. Another contributing factor has been the low return on deposit instruments. This low return, combined with a lessening of confidence in deposit-taking institutions at a time when the accumulated financial wealth of many Canadians surpasses the Canadian Deposit Insurance Corporation ("CDIC") maximum at individual institutions, has caused people to look to other investment vehicles. A further contributing factor is that providers of financial services are structuring their activities and products to reduce or eliminate their market risk. Securitization is one example of the risk-minimizing activities of financial intermediaries.

The replacement of defined benefit pension plans with defined contribution arrangements, including group and individual RRSPs, is another example of the transference of market risk to individuals. Individuals who were once insulated from market risk are now faced with day-to-day fluctuations in the market value of their retirement savings and the requirement to take responsibility for making the right investment choices. Much of the growth in the investment fund industry is attributable to the increasing preference of individuals for third-party, professionally-managed products rather than for direct securities holdings and is also indicative of a growing preference for and acceptance of diversified, lower volatility approaches to individual investments.

Other Strategic Forces

Other strategic forces that were identified by industry participants as impacting on the investment fund industry are related to the economic outlook, interest rate levels, political uncertainty, foreign competition, taxation issues, industry and product regulation, technological advances, industry participants attempting to gain market share in an overly-competitive way, mismanagement, competitive pressures to develop an increasing range of products and to achieve performance results, the need to differentiate product to increase market share, the exposure of the industry to large numbers of "first-time investors", the divergence of views of the constituent parts of the industry, the ability to access the capital that is necessary to finance operations, and the possible loss of credibility with investors.

2.02 Implications of the Shift to Fee-Based Businesses

Fee-based businesses, especially asset management businesses, are expected to become the major competitive area in the financial services industry. In this respect, in addition to the strategic shifts being made by financial institutions from a transactions-based business to a fee-based, relationship-driven financial services business, investment and other dealers are also pursuing fee-based revenue as a means of de-emphasizing the "feast or famine" earnings swings which are characteristic of the transaction-based retail securities business.

The Brokerage Industry

Investor Economics Inc. believes that the brokerage industry will be a major force behind the structural shift towards fee-based activities and the brokerage firms will be moving some of their existing clients to a fee-based system. This strategic shift in the business of brokers will be focussed on asset gathering, asset allocation services and asset management. With the goal in the 1990s being the success of the portfolio rather than the success of the transaction, there will be a need for the trading-oriented sales representative who controls the customer to evolve into, or be replaced with, a relationship-oriented manager who is comfortable with being a conduit for either internal or external money managers and who will relinquish some control over and ownership of the customer.

This transition will require significant investments in education, systems, training and back office operations and the modification of compensation structures to focus their base on assets under management rather than exclusively on commissions generated on specific transactions as has been the traditional basis. From the regulatory point of view, it is my opinion that it will be necessary to ensure that the regulatory system is designed to reflect the increased requirements in respect of educational requirements, training, systems and back office operations to support the shift to an advisory relationship.

The asset management services offered by brokers will compete directly with the comparable services offered by independent mutual fund organizations, financial institutions and investment counsel firms. The "wrap account" is described as being the entry mode of the '90s for the major retail brokerage firms into the world of portfolio management.

Brokers, in their transactions-based mode, have been the primary means through which independent investment fund organizations who do not have their own sales forces have accessed investors. In this mode, "ownership" of the investor has been viewed as residing with the sales representative rather than with the brokerage firm and "ownership" of the income stream generated by the investor's asset pool has been regarded as being owned by the investment fund organization. This structure has resulted in brokerage firms which have, in effect, rented out their high-cost distribution networks, being residual beneficiaries of the income streams generated by the asset pools. In this structure, brokers have had to contend with the fact that investment fund organizations often circumvent the brokerage firm management and deal directly with their "customer", the sales representative, thereby eroding an element of the brokerage firm's management and regulatory control.

The direct entry of brokerage firms into money management through product ownership is seen as providing such firms with greater authority over their sales force, the ultimate

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The expression "wrap account" is used by Investor Economics Inc. and others as being descriptive of and as a part of a generic class of fee-based money management products which include in-house broker-managed discretionary accounts, traditional multi-advisor/menu-driven wrap accounts, trust company IMAs (Individually Managed Accounts), investment counsellor segregated or pooled managed accounts, wrap mutual funds, broker-owned/managed funds, asset allocation products and traditional mutual funds.

customer, and most importantly, the income stream. The immediate implication of this transition is on the accessibility of major broker distribution networks to the investment fund industry. Although investment fund organizations will likely continue to have access to these distribution networks, Investor Economics Inc. believes that the channels will become even more congested and access to many may be limited. Given the number of companies offering investment fund products and the number of investment funds, the entry of brokers into this market with their own product means that "shelf space" will become even more limited.

This rationing of available distribution will inevitably put upward pressure on the cost of distribution. Investor Economics Inc. anticipates that brokerage firms will likely demand an increasing share of overall compensation which means that the sales representatives and the investment fund organizations will become residual beneficiaries in the compensation equation. The economic implications for investment fund organizations is a continuing squeeze on margins and/or more costs being passed on to their sponsored investment funds.

Investor Economics Inc. observes that compensation structures for the independent investment fund organizations, which are inextricably linked to the issue of distribution, will also be impacted by the new pricing paradigm that is reflected in bank no-load funds, non-bank no-load or level-load products and the fee-based products offered by brokerage firms.

The shift of customer preferences for no-load or level-load mutual funds and the increased customer awareness of the "real" cost of and the reduced flexibility of deferred load products is causing an industry shift to compensation structures which de-emphasize commissions and attach a greater importance to the sharing of the income stream. Investor Economics Inc. observes that in this environment, the dominance of deferred load products could be vulnerable and low load funds with very high service fees could become more prevalent.

Anticipated Reaction of Mutual Fund Organizations

Investor Economics Inc. observes that with traditional brokerage distribution channels squeezed, many investment fund organizations will be motivated to explore alternate distribution avenues and to strengthen existing arrangements outside of the major dealer networks.

They believe that discount brokerage firms will likely take on an increased importance as a conduit to retail customers as such firms represent an efficient way of channelling product to end customers at a competitive cost and that independent investment fund organizations will likely cultivate even stronger relationships with small and medium-sized brokerages and independent mutual fund dealers/financial planners.

Investor Economics Inc. suggests that the need to secure distribution implies that independent investment fund organizations might take equity positions in financial planning firms or acquire them outright. In other cases, firms may attempt to develop dedicated sales organizations as was done in the 1960s and 1970s and they note that this latter strategy lends itself to the evolving relationship needs of investors.

Another option identified by Investor Economics Inc. is for independent investment fund organizations to become more closely allied with financial institutions such as banks, trust companies and insurance companies who lack product, administration, service and/or money management expertise, in order to expand their distribution capabilities. Acquiring access to distribution can take a variety of forms including joint ventures, strategic alliances and advisory relationships.

Rationalization of the Investment Fund Industry

Investor Economics Inc. observes that there are too many managers who lack the critical mass and the ability to secure adequate distribution that will enable them to compete and grow in the market of the '90s. They observe that in a growing market, industry consolidations are not likely to be a painful financial process as in many cases firms will seek to combine operations to achieve critical mass. They think that there will also be ample opportunity for owners with a relatively secure asset base to cash-in as other firms seek to establish critical mass through acquisition. They observe that the brokerage industry appears to be a natural acquiror of investment counsel firms.

Summary

In summary, there is an intense struggle for distribution going on with an increasing need for firms to develop alternative business and product strategies to avoid the rationalization pressures that would otherwise result from the acute shortage of quality distribution. The ability to secure access to, and control over, distribution will be a critical determinant of success in the individual investment business. The strategic focus by all providers of financial services on the generation of fee-based revenue means that the productive worth of existing distribution networks will have to be maximized.

In summarizing the implications of the strategic forces affecting the investment fund industry, Investor Economics Inc. in its Study observed that:

> "In the years to come, all providers of financial services will compete for the hearts, minds and pocketbooks of the retail customer as never before. In a brutally competitive, deregulated, and de-pillared environment, the traditional boundaries no longer apply. The entire customer balance sheet is emerging as both the limiting factor and as an open battlefield".

3. WHAT IS HAPPENING IN THE INVESTMENT FUND INDUSTRY TODAY

In order to provide a further context for the consideration of the issues requiring a regulatory response and of the responses thereto which are recommended in this report, there is a need to be aware of how the strategic forces referred to in Section 2 are being reflected in day-to-day operations. Section 3 deals with some of the results of the pressures which have been brought to bear on investment fund managers, changing consumer attitudes and the competition for consumer savings. In addition, Section 3 outlines the investment fund industry's perception of the securities regulatory system. The information in this Section is based on what I have been consistently told by knowledgeable industry participants.

3.01 Pressures on Investment Fund Managers

The comment has been consistently made that virtually all aspects of the investment fund industry are being driven today by distribution and the competition for distribution. This

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Supra, note 4.

is not an overstatement. For all players there is a need to secure and build relationships with consumers. Independent investment fund organizations that do not have their own sales force must secure distribution channels in order to build the critical mass of assets under administration that is required in order to make their operations viable and profitable. This has resulted in intense competition by independent investment fund organizations for "shelf space" with distributors and in the costs of securing this distribution continually increasing.

In order to secure distribution, independent investment fund organizations have had to assume many third party distribution costs, pay increasingly high service fees, pay up-front commissions to compensate dealers where funds are offered on a deferred sales charge basis, pay reciprocal commissions and offer more and more incentives to gain and retain access to the distribution channels of investment dealers, mutual fund dealers/specialists and financial planners. These costs are often incurred at the expense of investors in their sponsored investment funds. For example, in order to secure access to distribution channels, some of the independent investment fund organizations have begun to perform back office functions for distributors without compensation, with the expense of this being reflected in higher management fees being charged to their sponsored investment funds. In some cases, independent investment fund organizations have provided mutual fund dealers/specialists and financial planners with computers and software to handle order flow. In other cases, mutual fund dealers/specialists and financial planners have pressured investment fund organizations to make equity investments in their operations or to loan money to them to finance their operations.

The need for independent investment fund organizations to sell through a third party distribution network and the "oversupply" of producers trying to access these networks has led to investment funds being regarded as "commodities" and to investment fund organizations being regarded as "manufacturers". A result of this perspective is that the independent investment fund organizations have increasingly become marketing companies, more focussed on gaining market share than on being investment management companies focussed on managing investment funds for the benefit of the investors in these funds. The major concern that arises from the focus on marketing

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This has been rationalized by regarding efforts aimed at increasing the size of an investment fund through additional sales as being in the interests of investors. Over the years there has been a lot of debate as to whether additional sales, in fact, are as much of a benefit to investors in the investment fund as they are a benefit to the manager of the investment fund, its shareholders and other stakeholders.

considerations is whether marketing considerations are prevailing over investment management decisions and resulting in conflicts of interest between the fund manager and the fund investors.

The need to gain or to maintain critical mass and/or continued "shelf space" with the distributors has put pressure on investment fund managers to achieve high short-term investment performance results and to be above the "averages" consistently. At the very least, this pressure on fund managers is a negative force in managing investments for investors whose investment horizon is the longer term. More troubling is the fact that this pressure may be resulting in questionable investment decisions and practices. It has been alleged that in order to achieve such performance, some fund managers may be engaging in inappropriate trading practices or making investments that are inconsistent with the fund's investment objectives. I understand that in some instances managers have aggressively sought product from issuers and have knowingly or unknowingly participated in aggressive trading aimed at establishing higher market prices and giving the appearance of there being a public market in circumstances where it was questionable whether there was one. I have also been told that it is not unusual for there to be transactions executed at the end of the day to establish favourable "closing" prices that are used for valuation purposes.

Another result that has flowed from the need to secure distribution channels is that independent investment fund organizations no longer appear to regard the investors in their sponsored investment funds as being their "customers" in terms of such investors being the persons whose needs, expectations and interests that their operations are intended to serve. Instead, these organizations regard the distributors - i.e. mutual fund dealers, mutual fund specialists, financial planners, investment dealers and, in some cases, the individual sales representatives that are employed by these firms - as being their "customers" and their immediate focus is on satisfying the needs of these people instead of the needs of the investors in their sponsored investment funds.

In the desire to build critical mass, there are some who seem to have lost sight of the fact that: (i) it is other people's money that is at stake, (ii) the privilege of managing this money is imprest with a trust, and (iii) both the money and the returns generated by the money belong to the investors and not to the managers and distributors. There seems to be an attitude among some industry participants that the managers and distributors are entitled to determine how much of the returns should remain with the investor and how much should be retained by the managers and the distributors. When market returns are high, the fact that this is happening is not as evident to investors.

The spiralling costs of distribution have put pressures on the profit margins of the independent investment fund organizations. These pressures are resulting in the costs of distribution being passed on to investors in the investment funds through higher management fees and through additional distribution-related expenses that are being charged to the funds. This trend runs counter to the fact that traditionally securities regulators have not permitted distribution costs to be charged to the funds. With the advent of deferred sales charges, this principle, perhaps inadvertently, seems to have been abandoned. I am also told that in some cases in an effort to improve profit margins, there are inappropriate and/or unreasonable allocations of expenses being made between the manager and the funds that are managed by the manager.

The pressure on profit margins is also having an impact on the ability of some managers to make the expenditures that are necessary to develop and provide the necessary infrastructure to support their operations including, technological and human resources, adequate systems, internal audit and other controls and procedures, and suitable disaster recovery systems. I am told that in some cases, managers, in seeking to improve their profit margins by reducing their expenses, do so at the expense of investors in their funds through various types of soft dollar transactions whereby expenses incurred by the manager are paid for by a third party in return for the manager allocating brokerage business to particular dealers.

Eroding profit margins have resulted in there being pressure on managers to seek alternative sources of revenue in order to improve their profit margins. Examples of this include establishing brokerage affiliates through whom portfolio transactions for the funds are executed and marking-up fees charged by affiliated service providers on services provided to the funds as part of the manager's obligations to provide services to the funds..

In addition, with the introduction of deferred sales charges to the Canadian scene, the "12b-1 expenses" for advertising that the United States Securities and Exchange Commission ("SEC") allows managers to charge to ***no-load*** investment funds in the United States started to be charged in Canada to ***all*** types of investment funds but without the limitation that exists in the United States as to the maximum amount of such expenses that may be charged.

Higher distribution costs and the timing for paying these costs have resulted in the need for some managers to raise capital to finance their distribution costs. A variety of methods have been used including conventional borrowing from financial institutions, equity offerings, debt offerings, limited partnership offerings and the securitizing of various income streams. The need to finance distribution costs gives rise to potential conflicts between the manager's obligations to the shareholders of the manager, the limited partners of the manager's limited partnership vehicles, the holders of the securitized interests and the investors in the funds. Managing these conflicts gives rise to an additional complexity in what should be a straightforward, simple business focussed on the management of the investment fund in the best interests of the fund investors.

It has been observed that every segment of the market has a distribution challenge and not just the independents who do not have their own distribution channels. For example, in the case of financial institutions that have a vast distribution system, some of the requisite skills to serve the investment needs of its clients are lacking. I am told that all managers have to solve their distribution problems in order to survive and grow and, accordingly, people are thinking about alternative distribution structures, including joint ventures, alliances and direct marketing. I am also told that in the long run, all suppliers, both on an individual and on a collective basis, have an interest in lowering the cost of distribution and that the high costs of distribution simply are not sustainable.

3.02 Changing Consumer Attitudes

At the same time that the industry is facing these distribution challenges, consumers have become increasingly aware of the fact that they must take charge of planning for their own retirement. This is due to a variety of factors including the uncertainty surrounding the availability and/or adequacy of the Canada Pension Plan and of employer-provided pension plans to fund their retirement years, the changing work environment where people no longer can expect to be employed by the same employer for the course of their working life, the shift from defined benefit pension plans to defined contribution plans or group registered retirement savings plans, increased personal savings, the changing needs of an aging population and the inter-generational transfers of wealth.

With this awareness has come the recognition by consumers that they need help in managing their affairs and they are turning to professionals for this help. Consumers are looking for more than just advice on what securities they should buy. They want help and advice in managing all aspects of their financial well-being including help in identifying realistic financial goals, the means of achieving such goals and identifying their tolerance for risk. In turning to professionals for help, consumers are often at a disadvantage because of their lack of knowledge about who they should look to for such advice, how they should be managing their affairs, what they should expect and how much should they have to pay for it.

In addition to these disadvantages, the average consumer is at a disadvantage because of the consumer's unequal bargaining power when faced with products that the consumer has had no part in developing and which are available only from institutions or through professional advisers who have an interest in or in respect of the products that they are recommending for purchase.

There is a growing recognition in the investment fund industry of the need to participate in increasing the knowledge and awareness of consumers. During the course of my discussions, I have noticed that attitudes seem to be shifting from a "buyer beware" stance to a recognition that in an environment based on relationships rather than simply transactions, there is a need to participate in the education of the consumer so that the consumer can participate meaningfully in developing and implementing the consumer's own financial plan.

Consumers also seem to be increasingly aware of the need to inform themselves and they are becoming more knowledgeable and demanding. One industry participant described the consumer demand as being "incredible - if you do not have a particular type of fund, you risk losing the consumer". I have been told that consumers are demanding 24 hour service, access to portfolio managers and to real-time portfolio strategy and holdings. Some of these consumers are using computer systems to track this information and are engaging in market-timing transactions based thereon. In effect, these consumers are acting as short-term traders, trading aggressively in the securities of the investment funds that they own on the basis of their assessment of the impact on the investment funds of market forces and/or portfolio transactions which are completed by the investment funds rather than acting as passive, long-term investors for whom the investment funds have been designed and are managed.

3.03 Competition for Consumer Savings

The current environment resulting from the distribution pressures discussed in Section 3.01 combined with the changing consumer attitudes discussed in Section 3.02, has produced a confusing array of product that is being offered to the consumer by a variety of participants some of whom have not previously been within the purview of the securities regulatory authorities and are not accustomed to counselling the retail investor/consumer. Segregated funds and variable annuity contracts offered by insurance companies are examples of investment funds that are outside of the securities regulatory purview. Similarly, some wrap accounts are the functional equivalent of investment funds but are not regulated as such.

It is increasingly difficult for the consumer, who is basically looking for independent money management and who is faced with a bewildering array of competing products, to understand what it is that is being offered and how such products may differ from investment funds that are regulated by the securities regulatory authorities or even that such products do differ. As has been pointed out by industry participants, it is also unfair from a competitive point of view for products that are basically the same to be regulated differently.

In order to gain market share, increasingly sophisticated and complex products are being developed and promoted aggressively. In many cases, the administrative costs to sustain these structures are very high and the integrity of the product is dependent upon the appropriate administrative procedures and controls being in place and being followed. Examples include fund of fund structures, multi-class offerings and structures designed to allow different investors to pay different management fees or to switch investments on a tax-free basis. Investments in novel or tax-oriented securities, with their concomitant valuation and liquidity issues, are another dimension in this environment.

3.04 The Perception of the Securities Regulatory System

The last major factor in the context of the discussion of what is happening in the investment fund industry today is the widely-held view that changes in the securities regulatory system are needed to serve the needs of the marketplace better. There are a variety of reasons contributing to this view but the ones that are of particular relevance in the context of this review relate to:

- ! the multiplicity of jurisdictions that regulate the offering and sale of investment funds;

- ! the multiplicity of regulators that have jurisdiction over various participants in the industry - they include the CSA, the Office of the Superintendent of Financial Institutions ("OSFI"), the provincial regulators of trust corporations and of insurance corporations, the federal and provincial regulators of pension funds, The Investment Dealers Association of Canada ("IDA"), the stock exchanges, the Canada Deposit Insurance Corporation ("CDIC") and the Canadian Investor Protection Fund ("CIPF");

- ! the lack of a coordinating mechanism among the foregoing regulators to ensure that there are no regulatory gaps arising from: (i) deregulation of the financial services industry, (ii) the entry of new industry participants into the marketplace, and (iii) the multiplicity of regulators having jurisdiction over various aspects of the business of the various participants in the industry;

- ! the lack at the regulatory level of a sufficient number of appropriately-trained and industry-experienced personnel;

- ! the lack at the regulatory level of adequate technical and other resources;

- ! the high costs of compliance with what industry participants see as duplicative, non-productive requirements in respect of the filing and registration requirements of the twelve CSA jurisdictions;

- ! the length of time it takes for filings and registrations to be effected; and

- ! the length of time it takes to develop new policy initiatives and to effect changes in existing policies, particularly as they relate to novel issues.

These factors are justifiably of grave concern to the investment fund industry and it is my recommendation that priority be given to addressing these concerns. Accordingly, my first recommendations relate to measures designed to address the concerns about the regulatory structure. In this respect, I think that there is no question about the need to streamline the regulation of investment funds. By this I mean finding ways to eliminate duplicative prospectus filing and registration requirements and to speed up the decision-making process.

Apart from the need, from both the perspective of the CSA and the industry participants, to eliminate duplicative prospectus filing and registration requirements and the time, resources and costs involved in this, there is a need to find a better way than currently exists to address the novel and complex issues that are required to be dealt with by the CSA.

Often staff of the respective CSA do not have practical experience with respect to investment funds and the issues related thereto and do not have the requisite skills to evaluate these proposals. In addition, none of the CSA is structured in a manner that results in core staff being dedicated to the regulation of investment funds. In this environment, when staff identifies a problem, it takes a long time to develop an approach to it within each of the CSA and then to coordinate this approach with all twelve of the CSA. This results in frustration by all concerned. The process takes even longer when the development of policy initiatives is involved.

I think that it is essential not only from the perspective of the industry participants and of the investors who ultimately bear the costs of regulation, but also from the perspective of the CSA and of the governments which created the respective CSA, to find a way to deal more effectively with these matters and to make better use of the respective resources. All governments are trying to do more with less and to get the best value for their tax dollars. The suggestions that I am making are aimed at outlining a way in which this might be done and in building upon what has been accomplished to date.

For the last ten years, the CSA have been concentrating their efforts in respect of the regulation of the investment fund industry on the development of uniform requirements for investment funds. At present, these uniform requirements are evidenced by National Policy No. 39 (which consolidates and restates the policy provisions of all of the CSA with respect to investment funds) and by National Policy No. 36 (which provides for a simplified prospectus offering system for investment funds).

Uniformity of regulatory requirements and harmonization efforts are commendable regulatory strategies that have worked relatively well in the past for the regulation of investment funds. However, in today's environment, where technology has in effect made the world borderless and eliminated time gaps, these strategies are no longer sufficient on their own. There is a need for a "next-generation strategy" that will facilitate the offering and sale of investment funds throughout Canada on a centralized basis while providing for the protection of investors' rights on a localized basis.

4. PROPOSAL FOR A NEW REGULATORY STRUCTURE

In making recommendations for a new regulatory structure, I stress that I am not concentrating on ***"who"*** is going to regulate but rather on **"*how*"** investment funds can be regulated in a more effective and efficient manner. The recommendations involve the creation of a new regulatory structure that will ***eliminate*** the need to deal with each of the twelve CSA jurisdictions separately in relation to prospectus and registration matters but will provide for the protection of investors' rights on a localized basis. The recommendations also involve the creation of a coordinating mechanism among a broader group of regulators to ensure that there are no regulatory gaps arising from: (i) deregulation of the financial services industry, (ii) the entry of new industry participants into the marketplace, and (iii) the multiplicity of regulators having jurisdiction over various aspects of the business of the various participants in the industry.

4.01 Centralization

The strategy that I am suggesting for accomplishing the objective of creating a regulatory system for regulating investment funds in a more effective and efficient manner is based on centralization. This strategy would centralize in one place staff with the requisite expertise, ability and credibility to identify, evaluate and make decisions in a timely manner on the regulatory issues affecting investment funds. Such centralization could be accomplished in a variety of ways including contractual arrangements among governments, operating agreements among the CSA, variations on the recently-announced selective review proposals or through the creation of a central commission. My recommendation is that centralization be accomplished through the creation of a central commission and my suggestions in this respect are detailed below.

4.02 Creation of a Central Commission

In order to achieve a centralized system of regulation, it is my recommendation that a separate organization (the "central commission") be established. In this respect, I suggest that a corporation, wholly-owned by the Crown in right of each of the Provinces and Territories of Canada, be incorporated to operate the central commission.

The central commission would function as an ordinary business corporation, accountable to the respective Crowns in right of the Provinces and Territories of Canada through the CSA in each Province or Territory.

4.03 Funding

The central commission would be funded by the fees payable by investment funds and registrants. To the extent that functions of the central commission are delegated to the proposed self-regulatory organization referred to in Section 9.02 (the "SRO"), an appropriate amount of these fees would be directed to the SRO. This could be accomplished by a reduction of fees payable to the central commission, the amount of this reduction being dependant upon a variety of factors such as the extent of the supervisory role of the central commission in relation to the SRO.

The net revenue of the central commission would be distributed pro-rata to the respective Provinces and Territories of Canada based on the volume of net sales in the respective Provinces and Territories.

4.04 Board of Directors

The board of directors of the central commission would be comprised of the CSA Chairs or their nominees. The board would ***not*** be involved in day-to-day operations but would be responsible for ensuring that there were adequate management personnel and systems in place for the central commission to function in an effective and efficient manner, for approving the strategic plans of the central commission and for approving its capital and operating budgets.

4.05 Staffing

The central commission would be staffed by skilled, knowledgeable personnel with industry experience. Although, there needs to be a reasonable degree of permanency, there is also a need to have some movement in and out of the group so that it does not function in isolation and remains current and responsive to industry issues. Ideally, a large proportion of the staff would have had a base of broad experience working within the industry or with one or more of the CSA or other regulators before joining the central commission. Staffing plans should focus on providing career paths for staff, on training and providing a variety of work, all of which is aimed at developing motivated staff who are able to deal with a full spectrum of issues.

The chief executive officer of the central commission would be appointed by the board of directors. The position would be a permanent one to provide for continuity and the chief executive officer would be expected to provide leadership and direction in ensuring that regulatory initiatives are keeping pace with and, in some instances, are perhaps ahead of industry developments.

4.06 Technological Support for the Central Commission

The functions of the central commission would be supported by modern information technology systems designed to link, on a real-time basis, the central commission with the CSA, the SRO, the users of the information technology systems and the public at large. Technology that effectively does this is currently available and is in place and working effectively in Australia.

4.07 Functions of the Central Commission

The central commission would be responsible for:

(1) developing all regulations, rules and policies relating to investment funds and for proposing appropriate legislative changes;

(2) handling all functions relating to the registration of managers of investment funds including investment counsel and portfolio managers;

(3) handling all functions relating to the registration of service providers to investment funds or to the managers of investment funds;

(4) handling all functions relating to investment fund prospectuses and continuous disclosure filings; and

(5) exercising regulatory oversight over the SRO.

The filing of material with the central commission would be the same as filing it with each of the twelve jurisdictions. The decisions of the staff of the central commission would be the same as if the decision had been made by staff of each of the twelve jurisdictions. In this respect the central commission would simply be an extension of each of the respective jurisdictions. Staff decisions would be appealable to the Commission of the central commission which is described in Section 4.08.

The specific details with respect to the functions of the central commission will be required to be worked out in the context of the follow-on work resulting from this report and the decisions that are made as a result thereof.

Reference is made to Section 14.01 with respect to the recommendations relating to the registration of managers of investment funds.

Reference is made to Section 14.03 with respect to the recommendations relating to the registration of service providers to investment funds or to managers of investment funds. With respect to the registration of service providers, it may be that in some cases, the functions of the service providers would make it more appropriate for the service providers to be registered with the SRO and subject to its direct oversight. If this were the case, it would be my recommendation that such service providers be required to be registered with the SRO rather than with the central commission.

The proposals made in Section 9.02 for the SRO contemplate that the SRO will assume responsibility for the registration of all dealers and that registration with the SRO will be effective throughout Canada, thereby eliminating the multiplicity of registration applications, amendments and renewals. If these proposals should not be implemented, it would be my recommendation that the functions of the central commission should include handling all registration matters.

The intention of my recommendation is that industry participants would have to deal with only one securities regulator and/or one SRO in order to carry on their operations throughout Canada.

4.08 Commission of the Central Commission

The central commission would have a Commission comprised of a cross-section of experienced, knowledgeable individuals appointed by the Lieutenant Governors of the respective Provinces from among names recommended by the board of directors of the central commission.

The functions of the Commission of the central commission would be:

(1) to hear appeals from staff decisions;

(2) to participate in the development of and/or the review and approval of policy recommendations, rules, regulations or legislative recommendations; and

(3)- to hear appeals from decisions of the SRO.

4.09 Enforcement Proceedings

Enforcement proceedings would be carried out by the respective provincial and territorial securities authorities with the cooperation and assistance of the central commission.

4.10 Compliance Proceedings

Compliance proceedings would be carried out by the central commission with the cooperation and assistance of the respective provincial and territorial securities authorities.

4.11 Other Matters

Many details will be required to flesh out and build upon the proposals outlined above. I contemplate that this would be done as part of the follow-on work resulting from this report if the recommendation for a central commission is approved in principle. My purpose here is merely to provide a conceptual framework for consideration rather than a detailed implementation plan.

4.12 Why a Centralization Strategy Should Work

One of the reasons why I think that the regulation of investment funds lends itself to a centralization strategy is the high degree of harmony and uniformity of regulation that currently exists among the CSA in respect of the regulation of investment funds. Another factor is that there do not appear to be any issues regarding the regulation of investment funds that are unique to any one jurisdiction.

5. COORDINATION OF ACTIVITIES OF VARIOUS REGULATORS

The deregulation of the financial services industry in Canada together with the internationalization of the global financial markets has led to new ways and means of doing business both in Canada and in the highly competitive, integrated world economy of today. One development has been the emergence of the financial conglomerate providing a wide range of financial services in a variety of geographic locations. Many of the financial activities undertaken by such financial conglomerates are subject to regulation, whether by banking, trust, loan, insurance or securities regulators. Often, even within a single jurisdiction, more than one regulator is involved.

Financial conglomerates pose difficulties for regulators. If, for example, one of these conglomerates were to encounter financial problems, a large number of its customers (be they depositors, insurance policyholders, investors or other creditors) could be adversely affected. There would also be implications for deposit and customer protection arrangements, as well as for insurance policies and premiums. Moreover, because of the linkages among global markets today, the potential for systemic risk is heightened - i.e. there is a greater risk that problems in a single entity or in one particular market segment will cause widespread difficulties at other entities, in other market sectors or in the financial system as a whole.

There is a need for cooperation among banking, trust, loan, insurance, pension and securities regulators (including the self-regulatory organizations such as the IDA and the stock exchanges and the customer protection organizations such as CIPF and CDIC). Not only does this need extend to cooperation among these regulators within Canada, it also extends to a need for cooperation among these regulators and their international counterparts.

5.01 Recommendations for a Coordinating Mechanism for Regulation

It is my recommendation that a Joint Regulatory Coordination Group consisting of representatives of the Canadian banking, trust, loan, insurance, pension and securities regulators (including the self-regulatory organizations such as the IDA and the stock exchanges and the customer protection organizations such as CIPF and CDIC) be established. The key function of this Joint Regulatory Coordination Group would be to provide a coordinating mechanism among the member regulators to ensure that there are no regulatory gaps arising from among other things: (i) the deregulation of the financial services industry, (ii) the entry of new industry participants into the marketplace, and (iii) the multiplicity of regulators having jurisdiction over various aspects of the business of the various participants in the industry. Another function would be to provide a similar coordinating mechanism with their international counterparts.

As proposals of this nature are being considered by others including the federal and provincial governments and IOSCO, I am not making any recommendations as to how this coordinating mechanism should be structured or how the coordinating work should be carried out.

6. USE OF TECHNOLOGY

Industry participants have brought to my attention the array of regulations, rules, principles and administrative practices that restrict the ability of registrants to use modern technology with respect to purchases and sales of investment fund securities. They have pointed out that these are artificial barriers, the removal of which could be accomplished without compromising investor protection. People want to be able to deal with registrants in a

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The material in this Section is extracted from the report entitled *The Supervision of Financial Conglomerates* which was published by the Tripartite Group of Securities, Insurance & Bank Regulators in April 1994 and is currently being considered by the IOSCO Technical Committee. A proposal for international cooperation among regulators is contained in the Tripartite Group's report.

manner of their choosing both inside and outside of normal business hours. The current rules about the time of day when an 800 number can be made available to investors and the jurisdiction in which these calls may originate and end are complex. They result in frustration for both the public and registrants. In my opinion, this is an area where regulatory requirements could and should be simplified without compromising investor protection. The recommendations outlined in Section 6.01 reflect proposals that are designed to do this.

6.01 Recommendations Concerning the Use of Technology

It is my recommendation that:

(1) There should be no restriction on the use by investors of toll-free lines regardless of the time of day or the place where the calls originate or end, provided that the calls are answered by or directed to persons who are registered sales representatives.

(2) Existing clients of a registrant should be able to communicate with the registrant in any manner that may be mutually agreed to. Accordingly, there should be no restriction on the use by existing clients of the registrant of automated banking machines or of other means of computer, electronic or technological access that are made available to such clients, provided that:

(i) the registrant is able to ensure that any transactions that are completed on behalf of such clients are completed in accordance with the know-your-client and suitability requirements;

(ii) the client has previously received the current prospectus disclosure documents required to be delivered before a transaction is completed;

(iii) the system is programmed to permit transactions only within a permitted

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Until registration is effected through the SRO referred to in Section 9.02, the sales representative receiving the call should be required to be registered only in the jurisdiction where the call is received. If the recommendations made in Section 9.02 for the establishment of the SRO are implemented, registration of the sales representative with the SRO would be effective throughout Canada.

"suitability" range and, in the case of any transaction that is not within the permitted range, the system is programmed to require that the transaction be referred to a fully-trained sales representative to deal with;

(iv) the system is designed to limit:

(a) access only to the accountholder or a person duly authorized by the accountholder to give instructions, and

(b) opportunities for fraud.

(3) There should be provision for the Securities Regulator to deny a registrant the right to use toll-free lines and provide the electronic, computer or other technological access referred to above if the Securities Regulator is not satisfied that the registrant has: (i) the capacity to comply with the foregoing requirements, or (ii) the necessary supervisory procedures in place to monitor such compliance as well as compliance with other applicable requirements of securities legislation and of the SRO.

7. MONEY MANAGEMENT - NEED FOR A COMMON REGULATORY STRUCTURE

Having considered the strategic forces affecting the investment funds industry (as outlined in Section 2) and what is currently happening in the industry (as outlined in Section 3), it is my recommendation that all types of arrangements whereby money is managed on a collective basis, directly or indirectly, for individuals be considered to be "investment funds" and be brought under a common regulatory structure. In making this recommendation, I am ***not*** suggesting that every requirement that is to be applicable to the most highly-regulated type of investment fund should be applicable to every product that is considered to be an investment fund.

What I have in mind is a regime that would build specific requirements for specific types of investment funds on a uniform base of core principles that would be applicable to all investment funds. For example, good faith requirements would form part of the uniform base of core principles that would be applicable to all investment funds regardless of what kind they were or who was offering or sponsoring them.

In my opinion, the regulatory requirements in respect of investment funds should apply equally to all industry participants and investors should be assured of certain common standards regardless of whether they are dealing with an independent investment fund organization, a bank, a trust company, a life insurance company or other financial institution, an investment counsel or an investment dealer, a mutual fund dealer or other category of dealer or a financial planner. I favour a functional approach to regulation over a structural approach thereto.

The recommendations contained in this report have been developed with this regulatory focus in mind notwithstanding the fact that the specific recommendations for the most part are expressed in terms of their applicability to open-end investment funds that are offered for sale pursuant to a prospectus. While I believe that the proposed framework will lend itself to other types of investment funds, time has not permitted me to develop specific recommendations for these other types of investment funds.

8. INVESTMENT FUND ACTIVITIES OF FINANCIAL INSTITUTIONS

8.01 Banks and Trust Companies

Currently, banks and trust companies may establish and manage their own investment funds and may distribute them through their branch network. For the reasons outlined in Section 7**,** these activities are and, in my opinion, should continue to be subject to regulation under the securities legislation of the various Canadian jurisdictions. To facilitate the regulation of these activities under securities legislation separate subsidiaries have been formed to carry on management activities, including portfolio management and, in some cases, distribution activities. The proposals contained in this report apply equally to the offering and sale of investment funds by banks and trust companies as they do to other industry participants.

At present, in the absence of exemptive relief being granted by the CSA, the Principles of Regulation do not permit banks and trust companies to sell third party funds through their

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Principles of Regulation Re: Distribution of Mutual Funds by Financial Institutions - Notice - Dated November 4, 1988 - Issued by the CSA.

branch network although they are permitted to sell third party funds through their discount brokerage firms. Among the reasons for this restriction on the sale of third party funds through branch networks are concerns about the adequacy of the education and proficiency skills of employees of banks and trust companies to sell investment fund securities to the public and the ability of such employees to comply with the know-your-client and suitability requirements before recommending purchases of investment fund securities to investors. These concerns are centred on the fact that employees in bank and trust company branches do not devote their full time and attention to investment fund sales but perform a variety of other functions for the bank or trust company and the fact that the traditional bank products substantially differ from investment fund securities.

Banks and trust companies have invested, and are continuing to invest, a lot of resources in upgrading the skills of their branch employees and in training them to assist clients in the choice of investment fund products. They have been sensitive to the criticisms made about the skills of some of their employees, about questions as to the suitability of certain recommendations that their employees have made about investments for certain clients, about confusion as to whether there is CDIC coverage for the amounts held in investment funds, about confusion as to whether there is any guarantee of "principal" or income and about the apparent lack of knowledge on the part of persons who buy bank or trust company sponsored investment funds that the value of their investment will vary.

Banks and trust companies have recognized that if they do not ensure that their "in-house distribution force" has an adequate level of knowledge and skills, they have as much of a "distribution" problem as do investment fund organizations that lack access to distribution channels and are fighting for market share. Banks and trust companies are addressing this problem pro-actively.

8.02 Sale of Third Party Funds by Banks and Trust Companies

Accordingly, in this environment and having regard to the desirability of broadening distribution channels for investment fund organizations, I recommend that the CSA review the Principles of Regulation with a view to removing the restrictions on the sale of third

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Supra, note 16.

party funds by banks and trust companies where the financial institution is able to satisfy the SRO and/or Securities Regulator that it has adequately-trained staff through whom such sales will be effected and that the financial institution has a compliance plan in place that will enable it to comply with the registration and compliance requirements and with the SRO membership requirements outlined in Sections 9 to 13.

The implementation of this recommendation should provide independent investment fund organizations with access to a broad distribution network and go a long way to reducing the problems raised by the shortage of distribution channels.

8.03 Commission-Based Compensation - Banks and Trust Companies

With respect to the current restrictions on the ability of banks and trust companies to remunerate their employees on a commission basis, some banks and trust companies have asked that these restrictions be removed. I am reluctant to recommend that this be done without further study of the matter. This study might well encompass the desirability of changing the basis of compensation for all participants in the industry with a view to better aligning the interests of the distribution force with those of investors.

8.04 Life Insurance Companies

Following changes made in 1961 to the restrictions on the investment policies of federal life insurance companies and the addition of enabling powers aimed at allowing life insurance companies to compete with trust companies for the business of administering and managing pension funds, life insurance companies have become significant competitors in the investment fund business.

See Sections 2 and 3 for a discussion of the problems raised by the shortage of distribution channels.

In December 1994, the CSA advised subsidiaries of Laurentian Bank of Canada (the "Bank") and Midland Walwyn Capital Inc. ("Midland") that they did not object to arrangements that were proposed to be entered into that would permit the sale of the Atlas Funds and of the Hercules Funds (which are investment funds sponsored by Midland's subsidiary, Atlas Asset Management Inc. ("Atlas")) through branches of the Bank, subject to arrangements for ensuring the confidentiality of the information relating to the Atlas client base being made to restrict the access of the Bank and its subsidiaries to information kept by Atlas which relates solely to clients of the Bank and its subsidiaries.

The 1961 amendments to the federal legislation governing life insurance companies (which have been reflected in comparable provincial legislation) were designed to enable life insurance companies to set up segregated funds with respect to which some of the investment restrictions applicable to life insurance companies would not be applicable, thereby enabling life insurance companies to invest extensively in equity securities. According to the Canadian Committee Report, while it was assumed that life insurance companies would make use of the enabling provisions only in connection with group life insurance and pension arrangements, they were not so restricted. In result, the legislative changes gave life insurance companies the power to issue on an individual basis policies under which a portion of the benefits payable is computed by reference to the value of a proportionate interest in a segregated fund. Many of these individual variable policies were and are designed to enable the policyholder to take advantage of income tax provisions for registered retired savings plans but others simply provide an equity feature in an otherwise conventional life insurance policy.

The Canadian Committee concluded in 1969 that segregated funds were directly competitive with open-end investment funds for savings dollars and that if they were to continue to be subject to different legislative regimes one might well have a competitive advantage over the other. The Canadian Committee therefore recommended that individual variable policies and the segregated funds upon which they are based should be subject to regulations similar to those that are applicable to open-end investment funds. In Section 16.34 of its Report, the Canadian Committee states:

> "As the competition between variable insurance polices and mutual funds becomes more aggressive, and the traditional differences between the instruments issued by the two industries decrease in importance, it becomes increasingly difficult to justify differences in the applicable regulations. Yet such differences continue to exist. As a result of historical accident rather than of any logical necessity, the differences relate to the regulation of variable benefits and the sale of the contracts, policies or agreements which

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Report of The Canadian Committee On Mutual Funds and Investment Contracts - A Provincial and Federal Study published in 1969 by the Queen's Printer for Canada (the "Canadian Committee Report").

Supra, note 20 - Section 1.28.

Supra, note 20 - Section 5.45.

> provide them. ... We do not believe that anomalies in the regulatory structure which result from historical accident and lack logical justification should be retained; this is particularly important when those anomalies provide one financial institution with a competitive advantage over another financial institution."

In Section 16.40 of its Report, the Canadian Committee states:

> "What is really needed is a more complete revision of the applicable legislation in order to provide a regulatory environment within which the competition between the mutual fund and life insurance industries can grow and develop in the public interest free of artificial constraints or competitive advantages for either industry."

There is even more reason 25 years later to reach the same conclusion when individual variable polices and the segregated funds upon which they are based are being sold today as the functional equivalents of open-end investment funds and the life insurance component has become subsumed to the investment fund component.

These individual variable policies and the segregated funds upon which they are based are often advertised as investment funds and have their contract price listed in the news media alongside the net asset values of open-end investment funds, despite the fact that they are not subject to comparable regulation nor are they subject to the same restrictions on the calculation and use of performance information in advertising and other sales communications. The public is often unaware of the differences between these products and the extent of such differences. I have been told that often many of the life insurance agents who sell these products and who are also licensed to sell mutual fund securities do not appreciate the differences between the life insurance variable insurance contracts and the mutual fund securities that they sell or even that there are differences.

I have been told that only 15% of the variable annuity contracts that are offered for sale today have an insurance component.

Another troubling area where the public is often not aware of the differences between products is with respect to the issue and sale of Labour Sponsored Investment Funds which are often marketed as mutual funds despite the very substantial differences that exist between a Labour Sponsored Investment Fund and a mutual fund.

There is virtually no substantive regulation of what features are integral to the individual variable policies and the segregated funds that are being offered today. For example, there are no requirements for "forward pricing" with respect to contributions and withdrawals, there are no requirements for financial statements to be prepared and delivered to policyholders, there are no audit requirements, there are no standard restrictions on investments and investment practices, there are no standards required to be set for the valuation of assets and liabilities and for the calculation of the contract value, there are no standard provisions relating to the standard of care that must be exercised in managing the segregated funds, there are no restrictions on "related party" transactions, fees are often high and are undisclosed, there are no requirements to obtain the approval or consent of policyholders to fundamental changes in the way the segregated fund will be managed and there are no standard provisions for winding up an unsuccessful segregated fund. In addition, while purchasers of a variable insurance contract must receive certain information (prescribed by the Ontario Insurance Commission), the disclosure is significantly less than that which is required with respect to open-end investment funds. This is of particular relevance in the case of group registered retirement savings plans that offer participants a choice among different types of variable insurance contracts. Minimal information is provided with respect to these investment choices in contrast to the information that is provided in the case of group registered retirement savings plans that offer participants a choice among different open-end investment funds where the prospectuses of such open-end investment funds are made available to participants and the investment funds meet the criteria specified in securities legislation and in National Policies No. 39 and 36.

Another area of difference relates to the proficiency requirements of the persons who offer variable insurance contracts for sale. The proficiency requirements applicable to salespersons who sell variable insurance contracts and to salespersons who sell open-end investment funds are substantially different despite the fact that the two products are functionally equivalent and are sold as such to the retail investor. In this respect, a major concern is the lack of emphasis that the requirements for registration under the Insurance Act places on the "know-your-client and suitability" requirements that exist in the case of investment fund sales.

Persons who sell variable insurance contracts are required to be licensed under insurance acts but not securities acts.

It has been observed that now that (i) there is provision for the dual licensing of persons to sell both life

I understand that the Ontario Insurance Commission is beginning to address some of the matters referred to above. While this is a positive step (and one that was recommended in the Canadian Committee Report), I think that there is a more basic issue to be addressed and that is whether individual variable insurance contracts and the underlying segregated funds, which are the functional equivalent of open-end investment funds, should continue to be exempted from the requirements of securities legislation. The substantial regulatory differences that exist argue for changes to be made to make securities legislation applicable to these products. The concerns arising from the substantial regulatory differences go beyond the lack of a level playing field. They go to the heart of investor expectations and protection.

Another question that should also be addressed is whether, from the point of view of the best use of tax dollars, it make sense to sustain and add to a separate regulatory regime for products that are functional equivalents of securities that are regulated under the securities legislation of the respective provinces and territories of Canada.

***Recommendation*s**

For the reasons outlined in Section 8.01 respecting the activities of banks and trust companies, the activities of life insurance companies with respect to variable insurance contracts, segregated funds, any other comparable products and the conventional open-end investment funds offered for sale by life insurance companies, should all be subject to regulation under the securities legislation of the various Canadian jurisdictions and to facilitate this, separate subsidiaries should be formed to carry on the requisite management and distribution activities. This is an area where I recommend that immediate

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insurance and open-end investment fund products, and (ii) broader options are available under income tax legislation to allow for the payment of a "Retirement Income" as defined in income tax legislation, the need for variable annuity contracts has disappeared.

I note that in many cases, life insurance companies have formed separate subsidiaries to carry on requisite management and distribution activities in connection with the offering of their own (or "private label") investment funds. These investment funds are regulated in the same manner as any other open-end investment fund that is offered for public sale and the subsidiaries of the life insurance companies are regulated in the same manner as any other registrant under applicable securities legislation. Accordingly, the effect of my recommendation is simply to include in this regime all of the products that have the attributes of an open-end investment fund.

action, consistent with the functional approach recommended in this report, be taken.

I also recommend that the same protection against the claims of creditors that is provided to holders of variable insurance contracts that are held in a registered retirement savings plan or registered retirement income fund be extended to securityholders of investment funds that hold their investment fund securities in a registered retirement savings plan or a registered retirement income fund. This would provide the holders of registered retirement savings plans and of registered retirement income funds that are funded with investment fund securities with equivalent protection against the claims of creditors that the holders of registered retirement savings plans and of registered retirement income funds that are funded with variable insurance contracts enjoy and with the equivalent protection against the claims of creditors that beneficiaries under registered pension plans have.

8.05 The Role of OSFI and of its Provincial Counterparts

A key focus of OSFI and of its provincial counterparts is and should continue to be the oversight of the capital adequacy and solvency of financial institutions. In this respect, I think it is essential that OSFI and its provincial counterparts have access to the necessary information to enable them to review, both initially and on an ongoing basis, the activities (including the "off balance sheet" activities) that are being carried on by the respective financial institutions, the respective organizational structures of the financial institutions, their internal governance and other supervisory procedures and controls with a view to assessing how these activities may impact on the capital adequacy and solvency of the respective financial institutions and enable them to take the necessary action to increase capital requirements or restrict certain activities. The effectiveness of the role of OSFI and of its provincial counterparts with respect to their overview of the capital adequacy and solvency of financial institutions should not be diminished by the fact that so much of today's activities of financial institutions are permitted to be carried on "off balance sheet".

In this respect, OSFI (and, to the extent applicable, its provincial counterparts) may well conclude that although financial institutions may be empowered by their enabling legislation to carry on a variety of activities, there may be some activities that should not be carried on in conjunction with other activities because they create added risk to the financial institution that cannot be adequately compensated for. For example, the fiduciary obligations of managing money on a discretionary basis combined with causing the discretionary account to purchase securities underwritten by the financial institution or by an affiliate of the financial institution or to purchase a derivative product offered by the financial institution or an affiliate of the financial institution could, in the event of loss, give rise to claims against the financial institution for breach of its fiduciary obligation that could impair its solvency. In addition, if financial institutions were to decide to buy back inappropriate investments (as has been done in the United States) to protect investors in their sponsored investment funds from loss, such purchases could impact negatively on the financial institutions.

Securities legislation looks at issues such as these from the perspective of the protection of investors. Financial institution legislation looks at such issues from the perspective of the protection of depositors, policyholders and/or shareholders or other investors. Both perspectives are legitimate ones and there is a need that both perspectives be addressed and not just one at the expense of the other. There is also a need to recognize and to address the fact that the controls that should be in place to protect the respective interests of depositors, policyholders and shareholders or other investors may not necessarily be the same and to seek the appropriate balance.

Recommendation

It is my recommendation that it be a responsibility of both the CSA and OSFI (and its provincial counterparts) to be satisfied that there is a viable combination of controls and limitations in place to be sure that the deregulation that has occurred in the financial services industry does not result in unsound business structures and practices either from the perspective of investors in investment funds sponsored by financial institutions or from the perspective of the depositors, policyholders and shareholders of financial institutions and of the other investors in financial institutions. This should be the prime function of the Joint Regulatory Coordination Group referred to in Section 5.01.

9. DISTRIBUTION OF INVESTMENT FUNDS

The discussion in the following sections of this report of the matters in respect of which I recommend that regulatory action be taken is divided into four broad areas:

- matters relating to the distribution of investment funds;

- matters relating to the management of investment funds;

- matters relating to the establishment of investment funds (including how they are structured and governed;

- matters relating to conflict of interest issues with respect to the management of investment funds.

Sections 9 to 13 deal with matters relating to the distribution of investment funds including conflict of interest issues with respect to the distribution of investment funds.

As noted in Section 3.01, the investment fund industry is driven by the current competition for access to distribution channels. Accordingly, it is essential that the regulatory strategies of the CSA address distribution issues in a meaningful way. In talking with industry participants about the regulatory approach to distribution matters, it was pointed out that although the CSA's current regulatory strategy is aimed at regulating the distribution of investment funds through the investment fund manager/principal distributor and the plan of distribution set forth in the prospectus of the investment fund, neither the manager/principal distributor nor the investment fund is in a position to exercise any real control over the distributors, their sales practices, how they handle client funds or other related matters.

I have been told that since the Competition Tribunal's actions several years ago that resulted in principal distributors not being able to require distributors to adhere to fixed sales charges, principal distributors have ceased to have the selling group arrangements with distributors that provided some degree of control over how securities of their sponsored investment funds were sold. Unfortunately, in view of the practices that exist in the distribution of investment fund securities today, it appears that the result that has flowed from the actions of the Competition Tribunal has had a negative impact on consumer protection and has not led to lower costs for consumers.

People have observed that with the maturing of the investment fund industry, investment fund securities are no longer "novel" products and that they have become more akin to "commodities". They have suggested that it is no longer appropriate to regulate the offering and sale of investment fund securities on a continuous basis as being a "new issues offering". They have suggested that once an investment fund has been qualified for sale to the public that all securities that are issued thereafter by the investment fund, regardless of when they are issued, should be treated as "outstanding securities" and that the requirements that relate to their sale should be no different than those that apply to the sale of other securities in the secondary marketplace.

There are elements of these matters with which I agree. The ones dealing with what the appropriate prospectus requirements are for an issuer that is in primary distribution are dealt with in Section 17 under the heading "The Disclosure System". The ones relating to regulating the distribution of investment funds are dealt with below.

9.01 Distribution Channels

Currently, investment funds are sold through members of the IDA, members of the stock exchanges in Canada, banks, trust companies and through mutual fund dealers who may call themselves mutual fund specialists or financial planners. In some cases, the mutual fund dealer is an affiliate of the investment fund manager and the sales force employed by the mutual fund dealer is referred to as being a "direct sales force".

There are substantial differences between the degree of regulation and controls that apply to the various categories of distributors, including differences as to capital requirements, contingency fund participation, supervisory procedures, the monitoring of compliance with regulatory requirements, insurance and bonding requirements, proficiency requirements, ethical conduct standards, business practice standards, insurance and bonding requirements and other matters. Very often the investor is unaware of or has no appreciation of these differences.

As a result of the pressures on investment fund managers to secure access to distribution,

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In some cases, investment funds are also sold directly by the investment fund. Direct sales do not generally give rise to the same problems as sales through third parties and therefore are not included in the discussion contained in this Section 9.

See Section 3.1.

questionable sales practices and incentives have become commonplace in the industry.

Among these sales practices and incentives (which are questionable both from the perspective of the investment fund manager that offers them and from the perspective of the distributor or sales representative that receives them) are reciprocal commissions, marketing allowances, cooperative payments, commission rebates, trips, service fees, assumption of deferred sales charges, bonus commissions and subsidization of capital and other costs of distributors. Another example of a type of sales practice that is more than questionable relates to the back-dating of orders. In the case of financial institutions, cross-selling practices that pressure clients to invest in the financial institution's sponsored funds as a condition of loans or other transactions are also examples of questionable sales practices.

In addition, as pointed out in Section 3.01, investment fund managers have been persuaded to pay sales charges, the costs of which are reflected in a higher management fee or, alternatively to integrate substantial sales charges into the management fee which results in higher fees and expenses being charged to the investment fund and reduces the investors' total return. The current descriptive term for these sales charges (which are also known as "service fees" or "trailer fees") is "advisory fees". However, some people describe these sales charges as simply being "bribes to distributors".

Regulators have been persuaded not to intervene in the case of sales charges but to let competitive market forces take their course and that their role should be limited to requiring that disclosure be made to investors. The same arguments have been made to me. It is my recommendation that the CSA adopt a regulatory strategy designed generally to let competitive forces take their course provided that certain fundamental actions referred to herein are taken. These actions include enhanced disclosure measures (which are discussed in Section 17), measures designed to increase the knowledge and awareness of investors (which are discussed in Section 15) and measures to regulate in a uniform manner the persons who sell investment funds to the public (which are discussed in Sections 9.02 and 9.03 in connection with the establishment of a strong, independent, effective self-regulatory organization that operates on a national basis).

In some cases, these sales practices and incentives are more than "questionable". They are wrongful acts. However, for the purposes of this report, I am simply using the descriptive term "questionable".

See Sections 13.02, 14.01 (Defective Systems and Procedures) and 27.06.

9.02 Establishment of a Self-Regulatory Organization

In talking with industry participants about what should be done to address the questionable sales practices and incentives and the other issues identified above, the advice that I was given was that there is a need to establish a strong, independent, effective self-regulatory organization (the "SRO") that operates on a national basis. There was virtually unanimous support among the people that I spoke with for the establishment of an SRO that would meet the above criteria.

Accordingly, it is my recommendation that a strong, independent, effective SRO be established that will operate on a national basis in which membership would be mandatory for everyone (regardless of their status) who is selling securities, including investment fund securities, to the public. The model that was suggested to me is the model used by the National Association of Securities Dealers, Inc. ("NASD"), the only self-regulatory organization in the United States that is registered with the SEC and whose membership includes virtually every broker/dealer in the United States that does a securities business with the public.

The only reservations that were expressed related to a concern that there might be several "self-regulatory organizations" and that if there were, a participant might find itself, because of its size, carrying a disproportionate share of the costs and responsibilities for self-regulation with no ability to exercise an equivalent amount of control over the standards. This is a legitimate concern which I believe is addressed by the recommendation that I am making.

The NASD was established under authority granted by the 1938 Maloney Act Amendments to the Securities Exchange Act of 1934. The NASD, through a nationwide system of local and standing committees composed of securities professionals, conducts regulatory reviews of members' business activities, develops rules and regulations, and designs and operates marketplace services and facilities. It carries out its regulatory responsibilities through member education, the registration and testing of securities professionals, on-site examinations of member firms to determine their compliance with federal securities laws and NASD rules and regulations, the review of members' advertising and sales literature, the review of underwriting arrangements proposed by members in connection with new securities offerings, and cooperative programs with governmental agencies and industry organizations to solve problems affecting investors, public companies, and member firms. The NASD provides a variety of services including arbitration to enable investors and members to resolve disputes and an 800 telephone number inquiry service that provides investors with disciplinary information regarding members and their registered representatives.

The above information is derived from the 1993 Annual Report of the NASD.

As in the case of the NASD, it is my recommendation that: (i) the establishment of the SRO be authorized by applicable securities legislation, (ii) the SRO be registered with the Securities Regulator, (iii) the SRO be subject to the regulatory oversight of the Securities Regulator, and (iv) the proposed rules of the SRO be subject to the approval of the Securities Regulator.

Among the reasons why an SRO of the nature described above makes sense is that there is no reason why investment fund securities that are sold to the public should be treated any differently from other types of securities that are sold to the public. In this respect, investment funds are gaining an increasing share of the business of the various distributing organizations and, in my opinion, it is no longer appropriate to regard the sale of investment fund securities as "fringe type activity" or "as not really being securities". I believe that this opinion is borne out by the strategic forces described in Section 2 and by what is actually happening in the investment fund industry today which is described in Section 3 of this report. There is also no reason, in my opinion, for some persons who sell securities, including investment fund securities, to be regulated differently from other persons who sell investment fund securities either alone or in conjunction with other securities. All of these persons are dealing with the public and the principles of financial responsibility, fair conduct and sound business practices should apply regardless of who you are or what securities you are selling.

There has been a lot of talk over the past several months about the possibility of combining certain operations of the IDA and the stock exchanges in a "Member Regco" which would consolidate the often overlapping regulatory functions performed by existing self-regulatory organizations and segregate them from market regulation and industry promotional activities. It is my recommendation that these talks be built upon and expanded to result in the creation of the SRO described above.

I do not think that it would be appropriate to have an SRO that would regulate the activities of its members only insofar as they relate to the sale of investment funds to the public. This type of fragmentation would result in an artificial division of activities and of needless duplication of regulatory requirements with the risk that some activities may fall between the cracks and put the member organizations, their affiliates and the public at financial risk.

In addition, the costs of an additional SRO for specified activities of member firms would serve only to increase the already high costs that are passed through in one form or another to the consumer without increasing consumer protection and with the possibility, as noted above, of creating gaps in protective coverage.

Accordingly, I think that the establishment of the type of SRO described above is an area where some visionary leadership is required from industry participants and the CSA in order to develop a self-regulatory system that is suitable for the marketplace of the mid-'90s and beyond.

9.03 Standards and Requirements of the SRO

The standards and requirements of the SRO that I am suggesting be established should include requirements in respect of a variety of matters. My recommendations in this respect are focussed on what the minimum requirements should be for firms which currently are not members of a stock exchange or of the IDA in respect of their sale of investment fund securities. These recommendations would also apply to firms that are currently members of a stock exchange or of the IDA, except that if the requirements of a stock exchange or of the IDA are currently higher than what my recommendations are, the higher requirements should apply.

Educational and Proficiency Standards

There is a need to upgrade the education and proficiency standards that would have to be met by directors, officers and sales representatives of member firms. My recommendations with respect to educational and proficiency standards are outlined in Section 15.

Minimum Capital Requirements

The minimum regulatory capital for a dealer that sells only investment fund securities should be set at $500,000. Consideration could be given to reducing this amount if all of such dealer's back office administrative requirements are being performed by a dealer-correspondent service that is provided by a firm that is a member of the SRO and is responsible for maintaining the dealer's trust accounts and for processing and settling all client orders placed with the dealer, provided that the minimum capital requirements of such correspondent member firm are set at a level appropriate to reflect the minimum capital requirements for the activities being carried on by the member firm.

In determining what the appropriate amount of minimum regulatory capital should be for a dealer that deals only in investment fund securities, it should be kept in mind that the cash float regarding client transactions can be very high. Figures that were quoted to me reflected that it would not be unusual for there to be an average weekly cash flow of $2 million, which if you divide by 5 means that there is an average daily cash float of $400,000. I am told that in many cases these numbers are higher.

Virtually everyone that I spoke with considered that there was a need to increase the minimum capital requirements. There is concern that some mutual fund dealers (which dealers are often referred to as "mutual fund specialists" or "financial planners") are undercapitalized and have not made the necessary investments in developing back office systems and procedures necessary to support their operations adequately. People have also expressed doubt as to the ability of some mutual fund dealers to satisfy any major legal claims that may be made against them. People have observed that there is no backstop for a major failure of a mutual fund dealer.

Contingency Fund Participation

Participation in an adequately-funded national contingency fund should be mandatory for all dealers. It is my recommendation that the CIPF be used for this purpose and that an appropriate formula be developed for determining the capital contributions that are required to be made in respect of investment fund sales.

I understand that there has been some industry discussion as to what the "right amount" is for the contingency fund contribution with respect to the investment fund activities by some of the current members of the IDA and that a suggestion has been made that member firms should segregate their investment fund activities in a separate subsidiary that would not be a member of the IDA so as to eliminate the requirement to contribute to the CIPF in respect of these activities.

In my opinion, this would be a negative step and should not be allowed to happen. The necessary work should be done to provide for one contingency fund that is national in scope and is adequately funded and regulated.

The current contingency fund in which mutual fund dealers participate should be rolled into the CIPF. This is an area which lends itself to the elimination of duplicative administrative structures, particularly when there are questions (as there are) as to the adequacy of the current contingency fund in which mutual fund dealers participate to meet claims in the event of a failure of a mutual fund dealer.

Some industry participants have questioned whether there is any need at all for a mutual fund dealer to participate in a contingency fund with respect to investment fund sales given the requirement in National Policy No. 39 that client funds be held in a trust account. In a perfect world where everything works all of the time as it is intended to, this might be a factor. However, we do not live in a perfect world and there would still be a risk of loss in the event of a failure of a mutual fund dealer if there were non-compliance with the requirements to hold client funds in a trust account or a court were to find that the funds were not properly segregated in a trust account. Accordingly, I think that there is a need to participate in the contingency fund. The fact that funds are or should be trust funds is one of the factors that I would think would be taken into account in determining the particular formula for CIPF contributions in respect of investment fund activities.

Some industry participants have suggested that the purchasers of investment fund securities should be assessed a special fee that would be paid into the CIPF to provide a contingency fund to protect investors against the failure of a mutual fund dealer and that the mutual fund dealer should not be required to make any contribution to the CIPF in this respect.

The current contingency fund in which registrants (including mutual fund dealers) that are not members of the IDA or of a stock exchange participate is known as the Ontario Contingency Trust Fund (the "Fund"). Participants contribute a deposit of $10,000 upon registration. There are approximately 256 participants in the Fund and the amount held in the Fund is approximately $2.6 million. Claims against the Fund (which may only be made by clients of registrants who are individuals) are limited to the size of the Fund, with the first $10,000 in claims against a participant being paid from the participant's deposit. Excess claims are assessed against the deposits of other participants. The maximum amount payable to any one client out of the Fund is limited to $5,000. Additional assessments against participants in the Fund are limited to $10,000 per year. Although the Fund has not had any significant claims since its establishment, there is concern that if there were to be a material failure by a participant, the current funding and funding arrangements would be insufficient to cover client losses.

Although this is an option that could be reviewed as part of the follow-on work resulting from my report, it is not one that I am recommending. It seems to me that the current formula for dealer contributions to the CIPF (3/16ths of 1 per cent of the sales commission) is probably the right approach. I do not see any justification for the consumer being assessed directly for this cost.

Know-Your-Client and Suitability Standards

There do not appear to be any "know-your-client and suitability" issues that are unique to investment fund sales. To the extent people commented on these requirements, the questions related to such matters as to what the responsibility is of a dealer, such as a discount broker, or of an investment fund that sells directly to the public, with respect to determinations as to the suitability of investments for the client in question.

It would be desirable to articulate some operating standards in this respect and also to clarify that "know-your-client and suitability" obligations are not just "account opening" functions but are required to be observed on a continuous basis in conjunction with continuing transactions that are being effected for the client.

There is a need to control the amount of information that can reasonably be required to be provided by a client with respect to satisfying the "know-your-client and suitability" obligations. Information designed to identify other selling opportunities or that will be used to put pressure on clients to deal with the firm with respect to other matters should not have to be provided by the client unless the client voluntarily chooses to do so.

Rules of Fair Practice

There is a need to develop rules of fair practice and ethical conduct standards that will protect investors from unfair business practices.

Rules of fair practice and ethical conduct standards are the core rules of the NASD. These rules require members to observe high standards of commercial honour and to follow just and equitable principles of trade. The rules provide for the imposition of sanctions for

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On sales commissions of $1 million, this amounts to a contribution cost of $1,875, which in many cases is no more than a person's annual car insurance premium.

failure to comply with the applicable rules and regulations. There is a need to ensure that we have comparable requirements in Canada respecting fair practices and ethical conduct and that these requirements are clearly articulated and are actively monitored and enforced.

Among the matters that would be addressed by such rules are the sales practices and sales incentives referred to in Section 10.

Business Practice Standards

There is a need to develop basic good business practice standards around which systems and procedures are designed. These systems and procedures need to be compatible with the systems and procedures referred to in Section 14 with respect to investment fund managers.

It should be a condition of registration that before a mutual fund dealer can commence business, it must be able to demonstrate that it has sufficient human and technical resources to ensure that it is capable of carrying out the necessary functions of its business. It must be able to demonstrate that it is organized and is able to control its affairs in a timely, effective and secure manner, maintain proper records and has adequate arrangements for ensuring that its employees and sales representatives are suitable, adequately trained and properly supervised. It must have well-defined procedures in place to ensure compliance with the requirements of the SRO and of the Securities Regulator. Further recommendations in this respect are contained in Section 13.

Advertising and Sales Literature

There is a need to develop standards for advertising and sales literature, to have procedures for reviewing and monitoring what is being used in this respect and to have effective sanctions in the event of non-compliance with the standards. While the provisions of Section 16 of National Policy No. 39 are a starting point in this respect, further work needs to be done in this area.

Two areas to which I draw particular attention relate to: (i) the lack of control over advertising and marketing materials that are developed and used by individual sales representatives without being reviewed and approved by the firms with which the sales representatives are associated or by the investment fund management organization, and (ii) the use of performance information generally. There is a need for the rules of the SRO to address both areas in a more satisfactory manner than is currently done.

Bonding and Insurance

Minimum bonding and insurance requirements should be established for mutual fund dealers and their sales representatives. As noted in Section 14.01, there needs to be an analysis done of the insurable risks and appropriate levels of coverage determined. This analysis needs to take into account the different ways that firms are structured and any increased risks to the public (as well as to the firm) that may result from how the firm is structured. In particular, there is a concern about the added risks to the public that may result from the lack of controls over sales representatives who are considered to be independent contractors as opposed to being employees of a firm. It may be that additional insurance coverage is required to be carried by these sales representatives.

I recommend that this analysis be undertaken as part of the follow-on work arising out of my recommendations. In conjunction with this analysis, consideration should be given to the establishment of a signature guarantee insurance program.

Registration of Mutual Fund Dealers and of Sales Representatives

There is a need to review the existing requirements for registration of mutual fund dealers and their sales representatives and to set appropriate standards for registration. Adherence to these standards should be a condition of continued registration and SRO membership.

Registration with the SRO should permit the mutual fund dealer and its registered sales representatives to operate throughout Canada subject to any conditions that may be attached to such registration.

My recommendations with respect to performance information standards are outlined in Section 24.

Reference is made to Section 11.03 respecting signature guarantees.

My specific recommendations with respect to registration matters are contained in Sections 12 and 13.

Supervisory Standards

There is a need to develop adequate supervisory standards that a mutual fund dealer is expected to follow to ensure compliance with securities laws and the SRO rules and regulations.

SRO Review of Member Firm Activities

There is a need for the SRO to develop a program that provides for periodic regulatory reviews of members' activities including on-site examinations of member firms to determine their compliance with securities laws and the SRO rules and regulations. These reviews should be conducted at least annually and it would be desirable for there to be a system that involves "surprise audits". In addition, there should be provision for requiring more frequent regulatory reporting or on-site examinations in circumstances where the SRO considers it appropriate.

SRO Sanctions

There is a need to ensure that the SRO is able to enforce compliance with securities laws and its rules and regulations. The SRO needs to be empowered and structured so as to ensure that it can take any necessary disciplinary actions on a timely basis for failure to comply. Among the powers that I recommend that the SRO should have in this respect are the powers to suspend or cancel or impose restrictions on the registration of its members including the directors, officers, partners and sales representatives of member firms.

Rights of Appeal to Securities Regulator

There is a need to provide for rights of appeal to the Securities Regulator from decisions of the SRO. What limitations there should be on these rights of appeal should form part of the follow-on work resulting from this report.

Granting of Exemptive Relief

The SRO should not be empowered to grant exemptive relief from securities law requirements (whether contained in securities law statutes, regulations or rules). Such relief, if it is to be granted, should be required to be granted by the Securities Regulator.

Remedial Actions

It has been suggested to me that the SRO should provide a means for arbitrating disputes between SRO members and their clients.

It has also been suggested to me that the SRO should operate an investors' hotline for questions and complaints about members.

A further suggestion has been made that an investors' ombudsman should be appointed.

These are all suggestions that merit consideration and I suggest that this consideration should form part of the follow-on work resulting from this report.

10. SALES INCENTIVES AND PRACTICES

As noted in Section 9.01, the regulatory strategy that I am recommending to the CSA to deal with questionable sales incentives and practices is to let competitive market forces take their course provided that certain fundamental changes are made.

One of these changes contemplates the establishment of the SRO described in Section 9.02, with one of its core requirements being the requirement to establish, monitor and enforce rules of fair conduct and business practices. While I contemplate that the development of these rules will be part of the follow-on work that results from this report, I would like to outline some specific matters that I recommend be taken into account in this respect. These recommendations should also be of assistance to the CSA if the SRO is not established and the CSA decides to become directly involved in regulating this area.

10.01 Trailer or Service Fees

In addition to the sales charges that are paid by an investor either at the time of an investor's purchase (front-end charges) of investment fund securities or at the time such securities are redeemed (deferred sales charges), sales representatives have arranged for managers of investment funds to pay them an additional sales charge which is commonly referred to as a trailer or service fee or an advisory fee. These fees are based on a percentage of the net asset value of an investor's interest in an investment fund and are payable on an ongoing basis to the sales representatives for as long as the investors own their investment in the investment fund.

Sales representatives say that these fees are to compensate them for ongoing services they provide to clients for such matters as answering inquiries about accounts, tax information and other related matters and for monitoring the performance of their clients' investments in the investment funds. The amount of the trailer or service fee varies.

Since the introduction of these fees in the mid-'80s, there has been continual pressure on managers to increase the amount that they are prepared to pay sales representatives on this basis. I understand that currently service fees are as high as 1 to 1.5 per cent of the investor's interest in the investment fund. This percentage is virtually the same percentage charged by highly trained portfolio managers for providing investment advisory and portfolio management services to the investment fund. There would appear to be an imbalance in such compensation both on an overall basis and relative to the level of services that are being provided.

As discussed in Section 3, the need for access to distribution channels has resulted in pressures on managers to pay ever-increasing trailer or service fees. If a manager does not agree to increase the amount that it will pay by way of trailer or service fees to what a competitor is prepared to pay, the manager can expect that the sales representative will cause his or her clients to switch their investments to an investment fund group that will pay the higher amount regardless of whether this benefits the client or has tax consequences for the client. The payment of high trailer or service fees by an investment fund manager may also be a factor in a sales representative not recommending a change in the client's portfolio when it would be in the client's interests to make such change. This is why some people have referred to trailer or service fees as being "bribes" and why there is a high level of concern about the conflicts of interest that exist between the sales representatives and their clients.

Another concern that has been expressed about trailer or service fees is that no standards have been articulated as to the services that are to be provided in exchange for the service fees. No one monitors whether in fact the services have been provided. In many cases, the investment fund manager continues to answer investor inquiries directly and to provide the investor services. The cost of doing this is reflected in the fees and expenses that are charged to the fund and which are in addition to the amount that is paid by the manager to sales representatives by way of service fees. In effect, investors are paying twice for services.

I understand that when trailer or service fees were first introduced, the intention was that the distributors would use these trailer or service fees to enhance their infrastructures to be able to deal more effectively and efficiently with client needs. This does not appear to have happened. Instead, investment fund managers have had to become involved in running distributors' back offices or providing distributors with the necessary computer equipment, software programs and other systems and procedures that are necessary to service client needs. These costs are often reflected in higher fees and expenses that the investment fund manager charges to the funds.

What is also happening is that funds that purport to be "no load" funds are building a trailer or service fee (which in effect is a sales charge) into the management fee. The only difference between this situation and what is described above is the implication, which is inherent in the use of the term "no load", that no sales charge is being paid by the investor. In fact, these funds are "level-load" funds and should be referred to as such. The term "no-load" should be permitted to be used only in respect of investment funds where there is no sales charge of any nature or kind payable at any time.

The major concern about trailer or service fees centres around the fact that despite the reference to these fees in the prospectuses of investment funds, investors are often unaware that these service fees are being paid to their sales representatives by the investment fund manager and that the cost of these fees is being passed on to investors through higher management fees that are being charged by the investment fund manager to the investment funds. There is also concern about the duplication of costs of services and whether, in fact, services are being provided that justify such costs.

In addition, there is concern that investors are unaware of the impact that trailer or service fees have on their total return both on an annual basis and on a compound basis over the length of time of their investment in the investment fund.

The situation that we currently have with respect to trailer or service fees is that fees for what are essentially transaction-centred activities are being charged at rates that are more usually reflective of full-scale investment advisory responsibilities and that these fees are in addition to the transaction fees. Investors have not yet comprehended this and accordingly are not able to decide whether the cost of the fees that they are paying is worth the service that they are getting or whether they even want the service.
The advent of trailer or service fees has been a major contributing factor to the questionable sales practices and incentives that have developed in the investment fund industry and that are discussed in Section 9 as well as in this Section 10. Another contributing factor to the questionable sales practices and incentives is that at approximately the same time that trailer or service fees were first introduced, securities regulators in Canada began to permit distribution costs to be charged to investment funds. Traditionally, the costs of distribution were required to be borne by the principal distributor/manager. Inroads were made on this principle when the industry started to charge a portion of the annual report costs to the investment funds. When this did not meet resistance from the CSA, the industry began to add other costs to what was charged to the investment funds such as a portion of the prospectus printing costs until gradually all distribution costs with respect to annual and interim reports and prospectuses were included. With the advent of deferred sales charges any remaining vestiges of the principle that distribution costs were not to be charged to investment funds disappeared.

Recommendations

(1) It is my recommendation that the CSA adopt (or re-affirm) as a fundamental principle, the principle that distribution costs may not be charged to an investment fund.

This principle should serve to get at the root of the problems relating to the way investment funds are distributed rather than just dealing with one of their manifestations as presumably managers will be motivated to bring the costs of distribution down when they impact directly on their profit margins and may not be passed on to their sponsored investment funds.

This fundamental principle of not charging distribution costs to an investment fund should be kept in mind when considering the appropriateness of any other sales practices and incentives.

(2) In the case of investment funds where the sales charge is built into the management fee, such as the "no load" funds described above or the "level load" funds that are gaining in popularity, competitive market forces should have an impact on this matter.

In this respect, the measures that I am recommending that are aimed at increasing the knowledge and awareness of investors and ensuring better disclosure of the fees, charges and expenses that investors are paying should result in investors having the relevant information and the ability to use it to allow them to make their own decisions about whether or not they want to pay these fees. If investors object to these fees and choose to invest in lower-cost comparable alternatives, the competitive pressures that are brought to bear on this issue as a result of this action by investors should result in these fees disappearing or being reduced to a reasonable level.

However, competitive market forces should be assisted by there being a requirement that where the sales charge is built into the management fee, such funds may ***not*** be described as "no load" funds but must be described by a term (such as "level load") that is descriptive of the fact that the investor is paying sales charges, albeit indirectly.

(3) Another strategy that might be adopted by the industry would be to decide voluntarily to end the payment of trailer or service fees. This is a strategy that the industry may well decide is desirable in its long term interests to adopt. If it does, it should be encouraged to do so and be commended for it.

Part of my reluctance simply to recommend that trailer or service fees be banned relates to the concern expressed by industry participants that banning these fees would just encourage sales representatives to increase the transactions within their

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See Section 15.04.

See Section 17.

clients' accounts or to abandon their clients after the initial sale. There is concern that even with enhancing the supervisory controls and procedures, it is unrealistic to think that the measures will be sufficient to prevent switching and churning of accounts.

10.02 Switching and Churning of Accounts

The rules of fair practice need to include enhanced measures designed to discourage switching and churning of accounts. As noted above, there is concern that if trailer or service fees are no longer paid, it can be expected that sales representatives and their firms will turn to switching and churning of accounts to generate revenues. Both of these practices are unacceptable sales practices and should raise questions about the continued fitness for registration of a registrant.

10.03 Compensation Systems

Compensation systems that result in there being pressure on sales representatives to engage in a volume of trading to get a larger portion of the commission earned on a trade should not be permitted. The so-called "grid" system not only encourages switching and churning, it is also inconsistent with the advisory relationships that firms are apparently trying to build with their clients as they adopt wealth management strategies.

10.04 Reciprocal Commissions

"Reciprocal commissions" is the term used to describe any commission payment resulting from the trading activity of an investment fund organization that is paid, directly or indirectly, (e.g. through a firm's institutional desk) to a retail salesperson based on the sales by such retail salesperson, or by the firm with which such retail salesperson is associated, of the securities of the investment fund organization's sponsored investment funds.

I understand that in response to pressures from retail sales representatives who are employed by major investment dealers, investment fund organizations are placing orders for the purchase and sale of portfolio securities for their sponsored investment funds directly with retail sales representatives who pass the orders on to the institutional trading desk for execution. The brokerage fees payable on the transaction are split between the retail sales representative and his or her firm in the same proportion that any retail brokerage order placed by the retail sales representative is split - e.g. 60 per cent for the firm and 40 per cent for the retail sales representative. There is a direct correlation between the orders that the retail sales representative receives from the investment fund manager and the number of securities of the sponsored investment funds that the retail sales representative sells.

A variation on the foregoing is for the investment fund manager to place the order directly with the institutional trading desk with a call to the individual retail sales representative(s) to tell them that the order has been placed and what proportion of it is "theirs".

I understand that by splitting orders and by by-passing the institutional trading desk, higher brokerage costs are incurred by the investment fund, with the retail sales representative benefitting proportionately.

I also understand that investment fund managers that manage money for other accounts, such as pension funds, will place orders for the purchase and sale of portfolio securities for their sponsored investment funds or for these other accounts with retail sales representatives on a retail basis in return for the sales representative having referred a pension fund account to the investment fund manager.

Questions have been raised about whether the investment fund manager is fulfilling its duty to obtain the "best execution" of its orders for its sponsored investment funds when the basis for executing the orders is apparently focussed on rewarding retail sales representatives for sales of their sponsored investment funds.

Apart from these concerns, there is concern about the interference by a third party (i.e. the investment fund organization) with the relationship between the investment dealer firm and its sales representatives. This interference makes it very difficult for the investment dealer firm to supervise its sales force which is very mobile. I am told that firms have very little control over the pressure that their individual sales representatives bring to bear on investment fund managers.

I understand that although the practices outlined above originated with retail sales representatives at the major investment dealer firms, it is now spreading to the sales

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The concept of "best execution" is discussed in Section 20.

representatives employed by the mutual fund dealers that call themselves "financial planners" or "mutual fund specialists". Some of these firms have bought seats on stock exchanges and are demanding that portfolio transactions for the investment funds whose securities they sell be executed through them in return for selling securities of the investment fund.

Recommendations

(1) It is my recommendation that the practice of allocating portfolio transactions for an investment fund on the basis of the sales made by a firm or its sales representatives of securities of the investment fund should be considered to be an unacceptable business practice.

This does not mean that portfolio transactions for an investment fund cannot be placed through investment dealer firms that also participate in the sale of securities of the investment fund if the basis for deciding to place the order with the firm is based on the bona fide decision of the portfolio manager that the factors that relate to obtaining "best execution" for the order have been met. These factors include research, statistical services, market price, volume, execution ability and costs. "Best execution" does not mean just the lowest commission as some have suggested.

(2) I recommend that to assist in monitoring this matter, provisions be adopted that are designed to ensure that:

(i) Investment fund organizations and the portfolio managers retained by them are prohibited from opening a brokerage account with a retail sales representative. In other words, their accounts should be institutional accounts.

(ii) Firms that execute portfolio transactions for an investment fund are prohibited from taking directions from investment fund organizations or from

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See Section 20 relating to the execution of portfolio transactions.

portfolio managers retained by them as to the direction of commissions or spreads on principal transactions.

(iii) Investment fund organizations and the portfolio managers retained by them are prohibited from advising retail sales representatives, directly or indirectly, that orders for the purchase or sale of portfolio securities have been placed with the firm with which such sales representatives are associated.

(iv) Investment fund organizations and the portfolio managers retained by them are prohibited from requesting, directing or in any way influencing how commissions or spreads on principal transactions are to be allocated by a firm that executes portfolio transactions for an investment fund.

(v) Sales representatives are compensated for their services by the firm for whom they work and not by anyone else.

The intention of these recommendations is that the arrangements between a firm and its sales representatives with respect to how sales representatives are to be compensated and what factors are to be taken into account in this respect, be a matter that is determined solely by the firm and its sales representatives.

10.05 Marketing Incentive Programs

There is a practice followed by some investment fund organizations to provide a marketing incentive program for sales representatives. Sales representatives are advised that for every so many dollars worth of investment fund sales they make they will earn points that are redeemable in products or services. All a sales representative has to do is present an invoice for the product or service and the invoice will be paid by the investment fund organization.

Recommendation

Investment fund organizations should be prohibited from paying anything, directly or indirectly, to or on behalf of sales representatives or their firms except sales commissions that have been disclosed in the prospectus disclosure documents. All payments owing by the investment fund organization in respect of such sales commissions on the sale of investment fund securities by sales representatives should be required to be made to the firm with which the sales representative is associated.

10.06 Trailer or Service Fees - Split Payments

There apparently is a practice followed by some investment fund organizations whereby only the firm's share of the trailer or service fee is paid to the firm. The sales representative's share of the trailer or service fee is held back by the investment fund organization and forms part of a pool of funds that the sales representative can draw on for products or services. The sales representative's share of the trailer or service fee is apparently not reported as income to the sales representative by either the firm (which has not made any reportable payment) or by the investment fund organization (which presumably treats these payments as being payments to independent contractors) with the result that unless the sales representative reports these benefits as income, the sales representative receives the benefits tax-free.

Recommendation

All payments owing by the investment fund organization in respect of trailer or service fees on the sale of investment fund securities by sales representatives should be required to be made to the firm with which the sales representative is associated.

10.07 Commission Rebates

Some investment fund organizations when they notice that a competitor's investment fund is experiencing performance weakness, in an attempt to gain market share, will offer to "immunize" investors in such fund from any redemption charges that may be payable by investors if they redeem in order to switch funds.

Apart from questions about predatory marketing, there are a variety of issues that impact on this practice including the fact the time period with respect to deferred sales charges starts running again, people end up selling at the bottom of the market and buying at the top, the process of switching will be a never-ending process in that performance is not a static matter, and it is pushing the business back to being transaction-based rather than relationship-based.

Recommendation

It is my recommendation that the practices involved in commission rebates by reason of the issues that they raise, be considered to be unacceptable sales practices and prohibited.

10.08 Trips and Other Non-Cash Sales Incentives

Expense-paid trips for sales representatives have been one of the main sales incentives used by investment fund organizations to encourage sales of securities of their sponsored investment funds. The nature of these trips has raised questions about the objectivity of the sales representatives' advice to their clients as to the investment funds in which their clients should invest.

"Trips" offered by investment fund organizations have many manifestations including educational conferences, due diligence visits, trade shows, seminars and road shows. Some of these are offered with the opportunity to add-on vacations or other benefits either at no cost or at a nominal cost.

In response to the negative publicity about trips and non-cash incentives the industry placed some restrictions on these. Currently IDA and TSE members are subject to by-laws that prohibit members or employees from accepting non-cash sales incentives in connection with the sale or distribution of investment fund securities. These by-laws also prohibit members from paying such non-cash incentives to its employees in connection with the sale of investment funds. However, mutual fund dealers (i.e. financial planners and mutual fund specialists) who are not members of the IDA or TSE (and who are responsible for approximately 50 per cent of the sales of investment fund securities) are not bound by these prohibitions and, I am told, aggressively seek to qualify for these sales incentives.

By-law 615 of The Toronto Stock Exchange defines the term "non-cash sales incentive" as including, without limitation, domestic or foreign trips, goods, services, gratuities, advantages, benefits, or any other non-cash compensation.

This situation is viewed as being inequitable and an incentive for sales representatives to leave member firms and join non-member firms. If my recommendation to require all persons and firms engaged in the distribution of investment fund securities to become members of the SRO is adopted, the result will be one rule for all.

Recommendations

(1) All persons and firms engaged in the distribution of investment fund securities should be subject to the same rules prohibiting them from accepting non-cash sales incentives as defined in the current by-laws of the IDA and TSE.

(2) Investment fund managers, as a condition of their registration, should be prohibited from offering non-cash sales incentives as defined in the current by-laws of the IDA and TSE.

(3) The practice which has developed in the case of some firms of soliciting contributions from investment fund managers towards defraying expenses of an educational conference sponsored by the firm should ***not*** be regarded to be permitted under the current TSE/IDA by-laws.

(4) Clearly-defined parameters should be established for sponsoring or arranging for bona fide educational conferences and seminars. These conferences and seminars can serve a useful purpose and should not be prohibited. Among the principles that I recommend be incorporated into these parameters are:

    (i) the requirement to share costs; such sharing of costs contemplates that as a minimum, the sales representative and/or the sales representative's firm will be responsible for the payment of transportation, accommodation and other appropriate costs;

    (ii) the requirement that attendance not be based on sales of the contributing organizations' investment funds;

    (iii) investment fund organizations should not subsidize the costs of attendance;

(iv) payments based on withholding amounts payable by the investment fund organization with respect to future sales that may be made by the attendees should not be allowed.

(5) Clearly-defined parameters should be established for due diligence visits and road shows which can serve a useful purpose and, accordingly, should not be prohibited. Among the principles that I recommend be incorporated into these parameters are, in the case of due diligence visits, that the cost of the visit must be paid by the sales representative or the firm with which the sales representative is employed. In the event that the firm pays, selection of the sales representatives to participate in the visit must be made by the firm and may not be based on sales of the investment funds of the investment fund manager whose offices are being visited.

In the case of promotional road shows put on by investment fund organizations, attendance at these road shows should be permitted if the event is in close proximity to the attendee's workplace or residence or the travel costs are not paid by the investment fund organization.

(6) Clearly defined parameters need to be established for reasonable business promotion activities such as tickets to sporting events, or theatre or other arts events and invitations to lunch or dinner which take place in the locale where the recipient is employed or resides. These parameters should apply to both the person or firm that offers the tickets or extends the invitation and to the recipient thereof.

10.09 Cooperative Advertising

The expression "cooperative advertising" relates to payments made by investment fund organizations to assist sales representatives and/or their firms in business promotion activities. These arrangements are on an individual basis where the investment fund organization agrees to pay up to 100 per cent of a promotional activity such as the cost of space at a trade show, the cost of preparing and sending newsletters and the preparation of a business plan.

These payments raise questions about the objectivity of the sales representative in making recommendations to his or her client. They also raise questions about the adequacy of the infrastructure and of the ability of the firm that employs the sales representative to sustain and to supervise the activities of the sales representatives.

Recommendations

(1) Rules should be developed that would prohibit both the investment fund organization from paying and the sales representative from receiving cooperative advertising payments.

(2) Investment fund organizations should be prohibited from paying, directly or indirectly, anything to or on behalf of sales representatives or their firms except sales commissions that have been disclosed in the prospectus disclosure documents.

10.10 Marketing Allowances or Bonus Commission

"Marketing Allowances" or "Bonus Commission" refers to the payment of money to a sales representative based on a mathematical calculation which is most often based upon the aggregate dollar amount of investment funds sold by the sales representative.

The issues here relate to disclosure to investors of the basis on which sales representatives are remunerated and to the fact that payments should be made to the sales representative's firm and not directly to the sales representative.

Recommendations

(1) If investment fund organizations have marketing allowances or bonus commission systems in place, the details of this arrangement should be disclosed in the relevant prospectus disclosure documents and in the information required to be given by the sales representative to his or her client at the point of sale together with an indication in the point of sale disclosure document of whether the sales representative and/or his or her firm is actually receiving such marketing allowances or bonus commission; in this respect, if the sales representative and/or his or her

firm has not qualified for the marketing allowances or bonus commission, disclosure in the point of sale document should be made so that the investor can assess whether the recommendation to invest in the fund is an impartial recommendation or is one that is motivated by the interests of the sales representative and/or his or her firm.

(2) All payments of marketing allowances or bonus commission should be made to the sales representative's firm and not to the sales representative.

10.11 Charitable Donations

Some investment fund organizations are apparently making charitable donations in honour of designated sales representatives or their dependents and directing the charitable organization to issue the receipts in the name of the sales representative.

Recommendations

(1) As a general principle, investment fund organizations should be prohibited from paying, directly or indirectly, anything to or on behalf of sales representatives or their firms except sales commissions that have been disclosed in the prospectus disclosure documents.

(2) In an extraordinary situation where there is a bona fide desire to honour an individual or firm, bona fide donations to a well-recognized public charitable organization could be permitted, provided that the receipt for such donation is issued to the investment fund organization that has made the donation.

10.12 Reimbursement of Expenses

In some cases, payments are being made to sales representatives or other persons or entities in which the sales representative has an interest as reimbursements for expenses incurred on behalf of the investment management organization as a way of providing additional benefits to sales representatives.

Recommendation

As a general principle, investment fund organizations should be prohibited from paying, directly or indirectly, anything to or on behalf of sales representatives or their firms except sales commissions and all such payments should be made to directly to the sales representative's firm and not to the sales representative or to a third party.

10.13 Other Matters

In the preceding sub-sections of this Section 10, I have outlined a number of questionable sales practices and incentives. It would not surprise me if there are others that have not come to my attention. It would also not surprise me if as soon as the ones listed above are eliminated or dealt with, other equally unacceptable sales practices and incentives will be devised.

Recommendation

It is therefore my recommendation that there be a fundamental general rule that investment fund organizations should not be permitted to pay, directly or indirectly, anything to or on behalf of sales representatives or their firms except sales commissions that are disclosed in a prospectus that has been filed with and accepted by the Securities Regulator and that all such payments be required to be made directly to the sales representative's firm.

11. BUSINESS PRACTICES

In conjunction with the follow-on work that results from this report, I would like to note some specific matters that I recommend be taken into account in developing business practice rules.

11.01 Commission Splitting

I understand that in some cases investment fund securities are being sold by life insurance agents or other persons who are not licensed to sell investment funds but who have an arrangement with mutual fund dealers and/or their sales representatives whereby the sales representative of a mutual fund dealer will put the order for the investment fund securities through in his or her name and will cause an amount equal to the sales charges or a proportion thereof to be paid to a company, the shares of which are owned by the life insurance agent (or other person, as the case may be) as a reimbursement of expenses incurred by the company for the benefit of the sales representative and/or the mutual fund dealer.

Recommendation

Practices of this nature which, circumvent or attempt to circumvent, securities legislation which requires that persons that sell securities to the public be registered to do so, should be prohibited.

11.02 Powers of Attorney

I understand that the practice has grown up whereby individual sales representatives receive powers of attorney from investors that in effect grant them discretionary authority over such investors' accounts. While the use of these powers of attorney may be limited, either expressly or implicitly, to carrying out the client's instructions to transfer investments between investment funds within the same investment fund organization, in many cases there is no limitation and the potential for misuse is great and needs to be addressed. This is particularly so when individual sales representatives or their firms request investment management organizations to redeem securities from clients' accounts to make either lump sum or periodic payments to the sales representatives or their firms.

Recommendation

(1) There is a need to develop business practice standards with respect to the procedures and controls that should be in place to ensure that powers of attorney granted by clients are not misused.

(2) As a minimum it would seem that there is a need to provide that individual sales representatives may not accept powers of attorney from clients. If powers of attorney are to be accepted at all, they should be required to be given in favour of the member firm and the member firm should be required to have systems and

procedures in place to control the circumstances under which the authority conferred on the attorney is exercised.

11.03 Guarantees of Signatures and Endorsements

There is confusion about the requirements with respect to guarantees of signatures and of endorsements, about who may provide them, what is being represented when such guarantees are given and what legal liability may be incurred by the persons who give and who act upon the signature and endorsement guarantees.

I understand that the basic practice of issuers and their registrars and transfer agents, where transfers or redemptions of securities are involved, is only to accept a guarantee of a signature or endorsement from a bank or trust company or a member of a recognized stock exchange**.** The reason for this is based on the assumed ability of such institutions or firms (which are regulated entities that are subject to capital and solvency requirements) to back their guarantees financially in the event of a wrongful transfer or redemption.

I understand that in recent years mutual fund dealers (who are not banks, trust companies or members of a stock exchange) often request investment fund organizations to accept their guarantees of their clients' signatures in lieu of guarantees by a bank, trust company or member of a stock exchange. There is concern in the industry that these firms do not have the financial backing necessary to honour these guarantees in the event of a problem and that there is a lack of internal controls and procedures with respect to what must be done when a guarantee of signature or of endorsement is given.

In response to similar concerns in the United States, the SEC adopted a rule affecting all "financial institutions" (including investment funds) that allows all participants to have equal access to securities transfer processing and is directed at ensuring that all companies guaranteeing signatures do it correctly and have sufficient financial backing to back up these guarantees. Registered transfer agents and others are required to establish written standards and procedures supported by written guidelines as appropriate for the acceptance of signature guarantees. The industry as a whole has agreed that all transfers or redemption requests will be rejected if the guarantor is not a participant in a program known as the STAMP program and the SEC has supported this by providing that

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"STAMP" refers to the Securities Transfer Agents Medallion Program offered by The Securities Transfer Association, Inc.

all signature guarantees after August 24, 1992 will require a STAMP medallion. In order to become a STAMP guarantor each participant must, among other things, complete an indemnity agreement and obtain a surety bond. Transfer agents and others who rely on a STAMP guarantor's guarantee are protected against loss from wrongful endorsement should a STAMP guarantor be unwilling or unable to meet its obligations under the indemnity agreement. The STAMP program was created for both the United States and Canada.

Recommendation

It is my recommendation that an industry-wide standard be developed for guarantees of signatures and endorsements. This standard might well involve a decision that mandatory participation in the abovementioned STAMP program is desirable. In the meantime, this is an area where it would be desirable for investment fund organizations to review their practices and procedures concerning the acceptance of guarantees of signatures and endorsements.

11.04 Leverage

Often sales representatives encourage their clients to borrow money to invest in investment funds and in doing so they often refer their clients to a financial institution or other lender who lends money to the client and who may pay a referral fee to the sales representative. It is questionable whether the client is aware of any such fee that is paid and whether the client understands the risk of having to sell the securities of the investment fund that the client owns in the event of a margin call that the client is unable to satisfy from other resources.

Apart from issues that exist between the client and the sales representative with respect to such practices (which issues relate to suitability, understanding of and tolerance for risk of loss, and possible payments of secret commissions), there is a concern that the leveraged position of investors in an investment fund may create problems for the investment fund that the restrictions on borrowing contained in National Policy No. 39 were

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I understand that so-called "loan and own" plans are quite common.

designed to prevent if there were to be massive redemptions in a falling market as a result of margin calls on investors who are forced to redeem their securities in the investment fund.

Recommendations

Business practice rules need to be developed with respect to the issue of leverage. Among the areas that should be addressed in such rules are (i) suitability issues (e.g. amount, terms of loan, nature of the investment and other assets available to repay the loan)**,** (ii) whether the loan is being made by a related party to the sales representative, the sales representative's firm, the investment fund(s) in which the investment is being made, or the manager or principal distributor of such investment fund(s), (iii) whether the sales representative or any of the persons referred to in clause (ii) is receiving any fee, payment or other benefit by reason of the loan being made to the client and the funds invested for the client, and (iv) disclosure of any such fees, payments or other benefits. These rules should be broad enough to deal with direct loans for investment purposes as well as indirect loans such as a mortgage where the proceeds from the mortgage loan enables the client to use other funds for investment purposes. Where any of these situations exist, conflict of interest issues are raised as well as suitability issues and disclosure issues.

There also needs to be some means for an investment fund organization to be made aware of the extent of leverage that exists in respect of their sponsored investment funds so that the investment portfolio may be managed taking this into account. However, I am not able to suggest any means for this that would not be viewed as being unduly intrusive on an individual basis. The potential problems in this area highlights the importance of there being sound business practice and suitability standards in connection with any recommendation to borrow money to invest in an investment fund. This is an area that I think that needs further study as part of the follow-on work arising from this report. It may be that if better liquidity standards are developed for investment funds (as discussed in Section 25.03) the concerns that are noted here become less of a problem, particularly in the case of a very large and widely-held investment fund.

11.05 Financial Assistance to Dealers or Sales Representatives

Business practice rules need to be developed with respect to dealers or their directors, officers, employees or sales representatives seeking to obtain or accepting financial assistance by way of a loan, guarantee or otherwise (including an equity investment) from investment fund organizations or any related party to such organization. Such transactions give rise to conflicts of interest and, where the dealer is in financial difficulty, can result in a continuation of practices and procedures that put the public at risk.

Recommendation

It is my recommendation that dealers, their respective directors, officers, employees and sales representatives or any related party to any of the foregoing should not be permitted to seek to obtain or accept financial assistance (whether by way of an equity investment or by way of loan, guarantee or otherwise) from any investment fund organization or any related party to such investment fund organization. There could be an exception provided in the case of financial assistance provided by a financial institution whose ordinary course of business includes the lending of money and such financial assistance is provided in the ordinary course of its business.

Where financial assistance is provided by a financial institution whose ordinary course of business includes the lending of money and such financial assistance is provided in the ordinary course of its business, it is important that disclosure of this forthwith be made to the SRO and/or the Securities Regulator so that both the source of the capital and the effect on net free capital balances is known. In addition, if the provision of such financial

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I have used the expression "related party" throughout this report without attempting to define the term because I think that the precise definition of the term should be developed in the context of the follow-on work that arises out of this report. It is my intention that the expression "related party" encompass the broadest range that is reasonable of persons that could be considered to have an interest in or exercise influence over the actions of the "base person or entity" in question. In this respect, it is my intention that the term have a broader meaning than is attributed to the concept of "related party" in the CICA generally accepted accounting principles and standards. Without limiting the generality of the foregoing comments, it is my intention that the investment fund manager and its related parties would be considered to be related parties of the investment funds sponsored by the investment fund manager.

Reference is made to the Settlement Agreement forming part of the Order made by the Ontario Securities Commission dated December 7, 1994 in the matter of First Investments Limited and Douglas K. Petitclerc, (1994) 17 OSCB 5857 which outlines business practices of the nature referred to in this Section and the nature of some of the consequences that flow from them.

assistance could result in conflicts of interest among the parties involved in the transaction and investors (including existing and future clients of the parties) the provision of such financial assistance should be made subject to conditions imposed by the SRO and/or the Securities Regulator. An example of one such condition would be a requirement that the financial assistance that is provided be subordinated.

If the above recommendations are not adopted and there is no restriction on the provision of financial assistance by an investment fund organization or any related party to such organization, it is essential that prior to any financial assistance being provided, full disclosure of the particulars of the financial assistance that is proposed to be extended be given to the SRO and/or the Securities Regulator and that disclosure be made to investors, including existing and future clients of the dealer.

12. REGISTRATION AND COMPLIANCE

Securities regulation in Canada is founded on two fundamental principles, namely, disclosure on a "need-to-know" basis of all material facts and registration of the persons who are permitted to deal with the public. As one of the cornerstones on which securities regulation is based, registration should be regarded as a privilege rather than as a right and the highest standards of good faith and proficiency should be applicable to it.

Unfortunately, for many years registration has been regarded as a somewhat mechanical matter that does not require much more than just checking items off on checklists. The number of categories of registration has increased with the result that several registrations are required to be obtained by the same entity to carry out functions that in many cases are ancillary to each other. Administrative procedures are such that different staff within each of the CSA are often responsible for the different categories of registration notwithstanding that it is the same entity that is being registered.

In addition, registration has been treated as a stand-alone function with virtually no resources of any of the CSA dedicated to having supervisory procedures in place to monitor compliance with the requirements of the applicable securities legislation and the conditions attached to such registration. Many of the registrants that sell investment fund securities are not members of the IDA or of a stock exchange with the result that these non-member firms are not subjected to any external supervisory reviews.

The recommendations contained in Section 9 for the SRO contemplate that the SRO will assume responsibility for the registration of firms and their directors, officers and employees (including sales representatives) and for exercising supervisory control over them. The recommendations contemplate that registration with the SRO will be effective throughout Canada, thereby eliminating the multiplicity of registration applications, amendments and renewals.

If the recommendations are implemented, the appropriate rules and regulations of the SRO to provide for this will be developed as part of the implementation procedures. No doubt these rules and regulations will draw heavily on the current registration requirements contained in the securities legislation of the various Canadian jurisdictions and on current rules and regulations of the IDA and stock exchanges.

There are some recommendations and comments about certain aspects of the current requirements that I recommend that the CSA take into account in considering the acceptability of the rules and regulations of the SRO or in making changes to the current CSA, IDA and stock exchange requirements if the CSA retains the responsibility for registrations.

Recommendations

(1) Minimum capital requirements, contingency fund participation requirements, insurance and bonding requirements and education and proficiency requirements all need regulatory attention without delay. My recommendations concerning these requirements are included in Section 9.03 with more detailed recommendations concerning education and proficiency requirements being dealt with in Section 15.

(2) The compliance functions should be integrated into the registration functions. There is a need to ensure that the necessary systems, controls and procedures are in place at the time of registration and then for there to be pro-active compliance audits, involving on-site examinations designed to monitor compliance with securities legislation requirements and the conditions of registration as well as to

identify weaknesses in internal controls and procedures. This is contemplated by the recommendations made in Section 9.03 with respect to the requirements for the SRO.

(3) There is a need to review the kind of information that the securities regulators are requiring or should be requiring in connection with an application for registration, amendment of registration and renewal of registration and the use that is being made of such information or that should be being made of it to determine what is important and what is not in exercising discretion to grant or refuse these applications.

This would help in streamlining registration procedures and would be useful in redesigning and simplifying registration forms.

(4) In the case of sales representatives, there is a need to clarify that their registration enables them to act only for the registrant with whom they are employed and that if they cease to be employed by such registrant, they are not able to sell securities until they are employed by another registrant.

This is a matter that I recommend: (i) be included in the education and proficiency courses that are required to be completed by sales representatives, and (ii) the restriction be endorsed on the sales representative's registration certificate.

(5) No-one should be able to be described as a "financial planner," a "financial advisor," a "financial counsellor," a "financial consultant," an "investment adviser," an "investment counsel", a "portfolio manager," or any other designation that is indicative of some special advisory or financial planning proficiency unless such person has successfully completed the requisite proficiency courses and has had the requisite industry experience and such person's registration reflects the appropriate proficiency categorization.

(6) There is a need to develop tracking systems with respect to all registrants, their

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See Section 15.03.

directors, officers and sales representatives in order to maintain historical records in retrievable form of any fraudulent activities in which any of them may have been engaged and of any securities-related offenses, offenses under various statutes that require licensing to deal with the public (such as mortgage-broker acts, insurance acts, trades qualification acts) and of any bankruptcy or other insolvency proceedings in which any of the foregoing persons may have been engaged. If statutory authority is required for this to be done, it should be sought.

(7) There is a need to develop clear indicia of conduct that will be considered to be incompatible with registration or continued registration to deal with the public and for such indicia to be supported by the requisite statutory authority to enable the SRO and the Securities Regulator to refuse registration or to suspend or cancel registration in circumstances where the indicia exist. Confidence in our capital markets and investor protection makes this ability essential.

(8) In developing standards for registration and continued registration, these standards should not permit the registration of firms, or of sales representatives of these firms, where the sales representative(s) will be functioning as an "independent franchisee".

In this respect, I understand that it is not unusual for a mutual fund dealer to have a large number of sales representatives (in some cases more than 100) associated with it. These firms and sales representatives purport to be and to function as a major firm would but in effect the sales representatives "rent" the mutual fund dealer's name and operate virtually independently of any controls, procedures or supervision of the mutual fund dealer. In many cases, they work from their homes and have virtually no contact with their firm. They function as "independent franchisees" and pay only a small portion of their commission (15% or less) to the mutual fund dealer. They often place client orders directly with the investment fund organization and the transactions may or may not appear on the books of the mutual fund dealer. In addition, no-one is checking that the sales representatives are properly recording the orders that they are receiving or that they are maintaining proper books and records. The public is not usually aware of these arrangements or of the lack of controls.

It is virtually impossible in a situation like this for the mutual fund dealer, any self-regulatory organization or the CSA to know what orders have been received by the sales representative or to monitor compliance with the requirements of National Policy No. 39 and other self-regulatory or securities legislation requirements respecting the segregation of client funds in trust accounts, timing of order flow, pricing and know-your-client and suitability requirements.

To compound the problems, clients are often persuaded by sales representatives that to facilitate transactions, they ought to provide the sales representative with powers of attorney enabling the sales representatives to act on their behalf. I understand that in many cases, there are no restrictions in the power of attorney limiting the use that may be made of it and that, in some cases, attempts are being made to use the power of attorney to redeem clients' securities with the proceeds being payable to the sales representative.

The opportunities for wrongful action to be taken are virtually unlimited. It is not in the interest of the investment fund industry to allow situations such as this to continue. Hopefully, the industry will move quickly to address these weaknesses without waiting for regulatory sanction.

(9) To deal with the situation described in clause (8), it may be necessary for the industry to place some restriction on the percentage of sales commissions that a registrant may pay to its sales representatives in order to ensure that the registrant is retaining a sufficient amount to be able to have the human and technical resources in place to supervise the activities of sales representatives and to ensure that clients' interests are protected.

This suggestion is based on comments made by industry participants that the competition between some firms for sales representatives has resulted in a "pricing war", with firms having to agree to make higher and higher commission payouts to their sales representatives in order to attract and retain them. What is left for the

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Reference is made to the recommendations contained in Section 11.02.

firm is often not sufficient to provide training and support for the sales representatives or to support the internal controls and procedures and the supervisory structure that a firm should have in place to carry out its obligations as a registrant properly.

13. CONDITIONS OF REGISTRATION

Regardless of whether the registration function is carried out by the SRO or by the Securities Regulator, there are certain conditions of registration that should be required to be met by persons who are engaged in the distribution of securities to the public This Section contains recommendations and comments about certain aspects of the current requirements that I recommend that the CSA take into account in considering the acceptability of the rules and regulations of the SRO or in making or overseeing changes to the current CSA, IDA and stock exchange requirements if the Securities Regulator decides to retain the responsibility for registrations.

13.01 Back Office Requirements

No one should be able to be registered until the registrant is able to demonstrate to the SRO or the Securities Regulator that it has sufficient human and technical resources to ensure that it is capable of carrying out the necessary functions of its proposed activities. In this respect, the registrant must be able to demonstrate that it has the infrastructure in place to fulfil its back office administrative functions in a timely, effective, efficient and secure manner. These functions include order taking, order processing, segregating client funds and securities in trust accounts, account inquiries, confirmations and other administrative procedures.

Internal controls must be in place and applied on a continuous basis. These internal controls should include procedures designed to monitor compliance with regulatory requirements as well as to prevent and detect fraud. There must be trained personnel responsible for designing and monitoring the applicable controls and procedures.

A self-assessment review program similar to the "SARP" program described in Section 14.01 should be developed for registrants and it should be a condition of continued registration that each registrant be required to demonstrate compliance with the standards that are developed. A continuous review program should be instituted in this respect with compliance certificates being required to be filed with the regulators on an annual basis and with provision being made for the SRO or the Securities Regulator to require more frequent reporting if the work of the SRO and/or the Securities Regulator should indicate potential problem areas. The self-assessment review program should be designed to supplement the work of the SRO and/or Securities Regulator's compliance reviews as well as the work of the registrant's external auditors.

13.02 Settlement, Clearing and Disaster Recovery Systems

An industry-wide settlement and clearing system should be established and it should be a condition of registration that everyone who is engaged in the distribution of investment fund securities participates in it.

A lot of work has been done by industry participants to identify the common requirements for a centralized settlement and clearing system on a cross-industry basis. Substantial agreement has been reached about what is needed for such a system and a set of common requirements for all industry groups as well as requirements specific to individual groups and attributable to the different roles they play in the investment fund industry has been developed.

The outstanding issues relate to who is going to operate the centralized settlement and clearing system and whether existing order processing systems that are used by several investment fund organizations and by mutual fund dealers that are not members of the IDA can be made compatible with the settlement and clearing system that is proposed to be used by IDA members. If the answer to the latter question is yes, it seems (at the time of writing this report) likely that CDS will operate the settlement and clearing system.

Recommendations

(1) It is my recommendation that the CSA encourage the industry to reach this accommodation and to proceed with the establishment of a centralized settlement

and clearing system, operated by CDS or another entity that is regulated in a comparable manner, in which every person or firm that is engaged in the distribution of investment fund securities is required to participate.

What is being contemplated by the industry is a centralized network capable of performing all back office functions including settlement and clearing. This will require the establishment of standards and it is important, for the reasons discussed in Section 9.03, that the systems and standards be designed around good business practices. For this reason, there needs to be some regulatory oversight of the settlement and clearing system and it is desirable, from a regulatory point of view, that it be operated by an entity, such as CDS, that is subject to this oversight.

The sooner that the centralized settlement and clearing system is operative, the better it will be for the industry which too often has lacked, and still lacks, the infrastructure necessary to process the volume of orders and to reconcile client positions. This is an area of great vulnerability that should not be allowed to continue.

(2) Among the matters that I recommend be taken into account in designing the system are the following:

(i) Although I understand that it is not necessary for the settlement system to tie into the clearing system, it would be desirable for it to do so, particularly when the infrastructure is in place at CDS for this to happen and for the settlement and clearing system to tie into the Canadian payments system as well.

(ii) Although I understand that it is not necessary for there to be only one settlement system, it would be desirable from the point of view of standardization and efficiency to encourage the development of a single system.

(iii) In developing operating standards for the settlement and clearing system, there is a need to ensure that the procedures developed for the correction of errors do ***not*** involve back pricing of orders because of the potential abuse that can occur.

(iv) There will be a need to align some of the provisions contained in Sections 11, 12 and 13 of National Policy No. 39 with the operating procedures that are developed for the settlement and clearing system. Among the matters to be addressed in this respect are settlement dates, the extent to which net settlements can be made and error correction procedures.

(v) With respect to settlement dates, the period for settling both purchases and redemptions of investment fund securities should be shortened to "T + 3" to coincide with the advent of electronic order processing and the implementation of the shorter settlement date for other securities transactions.

(vi) There is a need to provide for timely transfers from one registered retirement plan to another. The delays in processing these transfers are not justifiable. With the advent of electronic order processing, there is no reason why the industry cannot develop procedures that will enable these transfers to be processed within the same time limit as any other redemption.

(vii) There is a need to provide for standards and systems that will result in there being no "off-book" transactions.

(viii) There is a need in conjunction with the settlement and clearing system to provide for adequate disaster recovery systems to ensure the timely recovery of essential data in the event of a disaster occurring, electronic or otherwise.

(3) Every registrant should be required to establish, and to require any third party that it has retained to provide services to it to have or to establish, adequate disaster recovery systems to ensure that vital records are not lost in the event of a disaster occurring, electronic or otherwise, and to provide for the timely recovery of essential data in such event. It would be desirable for there to be industry-wide minimum

standards to be met in this respect.

This is an area that I recommend be reviewed by the CSA and opinions (supported by actual testing) be obtained as to the adequacy of the standards that are developed.

I recommend that priority be given to this matter.

13.03 Detection of Money Laundering Activities

Every registrant should be required to establish procedures designed to detect and report money laundering activities.

13.04 Registrants Acting as Trustees of Tax Deferred Plans

No registrant should be permitted to act as a trustee of a registered retirement savings plan, registered retirement income fund or other such plans, whether self-directed or otherwise, unless:

(1) such registrant is a member of the SRO;

(2) the SRO is satisfied that the registrant has sufficient controls in place to ensure that:

 (i) the client's assets are segregated in a separate trust account maintained for such client; and

 (ii) such assets are protected from the claims of creditors of the registrant; and

(3) the SRO is satisfied that the registrant has sufficient knowledge of its prudential obligations under applicable tax legislation and under the terms of the declaration of trust establishing the plan to carry out such responsibilities adequately.

13.05 Measures Designed to Reduce the Incidence of Fraud

Industry input needs to be sought for measures designed to prevent fraud or to assist in detecting it at the earliest opportunity. Sound business practices combined with good internal controls and procedures, vigilant supervisory procedures, diligent internal and external audit procedures and on-site inspections on a periodic as well as on a surprise basis will help.

However, these measures will not address the problems that can arise if the orders and money are never transmitted to the firm in the first place or, when transmitted, are not recorded on the books of the registrant. These latter transactions, which are colloquially referred to as "off-book transactions", substantially increase the risk of fraud.

Recommendations

(1) In addition to measures of the nature referred to in the recommendations contained in Section 12 and in the preceding subsections of this Section 13, requirements that cheques be made payable to the investment fund directly or to the distributor in trust for the investment funds would help. Requiring the posting of fidelity and performance bonds for sales representatives would also help.

(2) Measures aimed at reducing the delays in transmitting money to investment funds and from investment funds to clients should also help in that they will provide less opportunity for unauthorized use of the funds by sales representatives and/or the firms with which they are employed. Sections 11, 12 and 13 of National Policy No. 39 were designed to reduce these delays. It will be important in developing the operating standards for the settlement and clearing system referred to in Section 13.02, that the importance of this matter not be lost sight of. The proposed procedures should be reviewed by persons with specialized training, such as forensic accountants, for their adequacy in this respect.

(3) More frequent reporting of client positions would also help. In the desire to

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An example of what can occur in this respect may be seen in the facts set forth in the Settlement Agreement forming part of the Order made by the Ontario Securities Commission dated December 7, 1994 in the matter of First Investments Limited and Douglas K. Petitclerc, (1994) 17 OSCB 5857.

streamline operations and reduce administrative costs, there have been several exemptions, interpretations or waivers of reporting requirements that have resulted in less frequent reporting or trade confirmations being provided. This area needs to be looked at again from the perspective of whether the result has been to increase the opportunity for dishonest behaviour. The assistance of persons with specialized training in the detection of dishonest activities, such as forensic accountants, should be sought in this respect.

(4) Another measure is to ensure that investors are advised as to how the system is supposed to work so that they know what they should expect and when.

(5) Additional measures would include having statements and confirmations prepared on forms that are not readily reproducible to discourage falsification of these documents and requiring these statements to be issued by the investment fund organization and not by the dealer.

(6) Most importantly, if there were an expectation that fraudsters would be caught and dealt with appropriately, such expectation would probably act as a deterrent to fraudulent activities. Misappropriation of client funds should, in addition to normal penal sanctions, be unacceptable conduct for a registrant resulting in automatic suspension of registration and ineligibility for reinstatement of registration or for a new registration.

14. MANAGEMENT OF INVESTMENT FUNDS

The second broad area in respect of which I recommend that regulatory action be taken relates to the management of investment funds. My recommendations in this respect are set out in this Section 14**.** In considering these recommendations, it should be kept in mind that the general practice in connection with the establishment of investment funds is for an investment fund organization to cause an investment fund to be established on the basis that the investment fund organization will be responsible for providing or causing to be provided to the investment fund all of the services required by the investment fund to carry on its operations in the ordinary course. In many cases, the investment fund is established by an investment fund manager pursuant to a trust instrument that provides for it (or its affiliates) to be the trustee and manager. In other cases, the investment fund is established as a corporation, with the investment fund manager and/or its affiliates providing the requisite services to the investment fund pursuant to contractual arrangements that are entered into.

14.01 Proposed Requirements for Investment Fund Managers

Currently, there is no requirement for investment fund managers to be registered with any securities authority in order to establish and operate investment funds. In addition, there is no requirement that the investment fund manager have any "outside directors" - i.e. individuals who are free of relationships and other interests which could, or could reasonably be perceived to, materially interfere with the exercise of judgment in the best interests of the corporation or that the investment fund manager have an audit committee. There are also no requirements with respect to minimum regulatory capital, insurance or bonding coverage, adequacy of management resources, competency and proficiency of personnel, adequacy of internal systems, controls and procedures, or procedures for monitoring the same. In addition, there is no requirement in the case of the investment funds sponsored by the investment fund manager that the sponsored investment funds have independent boards.

In my opinion, there is something inherently wrong with a structure that permits all of the functions that are required to be carried out in respect of an investment fund to be carried out by related parties on terms that in effect are unilaterally imposed without there being some degree of review by unrelated persons as to the manner in which the obligations are being carried out and, in the case of the investment fund, some degree of review by unrelated persons who are considering the fairness of the matters from the perspective of

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Registration is only required in the context of distribution functions and in the context of investment advisory activities. The requirements for these types of registration are not necessarily the same ones that should be applicable to an investment fund manager.

This is the definition of "unrelated directors" used in the report entitled - "Where Were The Directors?" - Guidelines for Improved Corporate Governance in Canada - Report of The Toronto Stock Exchange Committee on Corporate Governance in Canada - December 1994. This report is often referred to as the "Dey Report".

The issue of whether investment funds should be required to have independent boards is discussed in Section 18.04.

the best interests of the investment fund and its investors. In the current structure, questions are often raised as to who is looking out for the interests of investors.

I think that there is a need to address the investor protection concerns that result from the current regime. I think that this could best be done by providing for investment fund managers to be registered and by specifying certain requirements that must be met in order to act as an investment fund manager, including minimum regulatory capital requirements, bonding and insurance requirements, provisions designed to ensure that the investment fund manager has adequate human and technical resources, effective and efficient internal controls, systems and procedures and the ability and obligation to monitor compliance with the same.

Recommendations

The following recommendations in this respect are made:

Registration of Managers

For the reasons outlined above, it is my recommendation that anyone that is acting as a manager of an investment fund - i.e. providing an investment fund with management or administrative services either alone or in conjunction with the provision of investment advice and whether such services are provided directly or through third parties, be required to be registered with the Securities Regulator to act as an investment fund manager.

The reason why I recommend that the Securities Regulator retain direct responsibility for the registration of investment fund managers is because the functions of a manager of an investment fund are so closely linked with the functions of its sponsored investment funds. It would be very difficult and inefficient to attempt to separate the regulation of the two. In my opinion, the establishment of investment funds and the disclosure documents relating thereto should remain the direct responsibility of the Securities Regulator and should not be delegated to a self-regulatory organization. Accordingly, the registration function with respect to managers of investment funds should also remain the direct responsibility of the Securities Regulator.

If my recommendations with respect to centralization of securities regulation should not be adopted, or pending the adoption of such recommendations, provision should be made to require that registration as an investment fund manager need be effected only in the investment fund manager's principal jurisdiction. The requirements of each of the CSA for such registration should, however, be identical to avoid "jurisdiction shopping" and to ensure uniformity across Canada of the provisions that are designed to protect investors.

I suggest that registration of managers of investment funds be a special category of registration within the adviser classification.

If the investment fund manager is also a distributor of investment funds, it should be required to be a member of the SRO described in Section 9 and to meet the SRO's requirements in respect of the investment fund manager's distribution functions.

Eligibility to Act as an Investment Fund Manager

It should be a condition of registration of an investment fund manager that before such manager can sponsor an investment fund, it must demonstrate that it has sufficient financial, human and technical resources to ensure that it is capable of carrying out the necessary functions of investment fund management. The investment fund manager must be able to carry out its obligations to act with due skill, care and diligence and it must be able to employ effectively the resources and procedures which are needed for the proper functioning of its sponsored investment funds. The investment fund manager must organize and control its internal affairs in a responsible manner, with proper records and adequate arrangements for ensuring that employees are suitable, adequately trained and properly supervised. It must have well-defined procedures in place to ensure compliance with regulations.

The foregoing principles are reflected in the IOSCO Principles and I recommend that they be reflected in the requirements for registration and continued registration of an investment

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The term "IOSCO Principles" refers to the Principles for the Regulation of Collective Investment Schemes and Explanatory Memorandum developed by the IOSCO Working Party No. 5 on Investment Management which forms part of the Chairman's Report to the Technical Committee - September 1994.

fund manager. Suggestions with respect to requirements that are aimed at reflecting these principles are outlined below.

Minimum Capital

During the course of my discussions with industry participants, questions were raised as to whether some organizations are perhaps undercapitalized, whether they have the requisite resources to invest in the necessary back office systems and procedures to support their operations adequately and whether they have the ability to satisfy any major legal claims that may be made against them. These are legitimate questions and need to be addressed by both the industry and the regulators.

It was suggested during the course of discussions that the minimum regulatory capital for investment fund managers should be set at a high enough level to ensure that the organization is sufficiently capitalized to provide quality staff, equipment, systems and services to support the assets of fund investors. In considering what the minimum regulatory capital should be for this purpose, it was suggested that the initial minimum regulatory capital should be set at $1,000,000 and should increase as fund assets increase according to the following scale:

Fund Assets	Capital Rate	Minimum Capital
Less than - $100 million	-	$1,000,000
$100 million - $200 million	1.00 %	up to $2,000,000
$200 million - $1 billion	0.25%	up to $4,000,000
$1 billion - $5 billion	0.10%	up to $8,000,000
$5 billion and over	0.05%	over $8,000,000

Whether these amounts are the "right" amounts will no doubt be the subject of a lot of debate. I have set these amounts forth for the purpose of indicating the magnitude of the amounts that are contemplated by at least some industry participants as being necessary and that I recommend that the CSA have in mind in setting minimum capital requirements for investment fund managers.

Increased capital requirements will help ensure that the investment fund manager is able to provide and maintain quality services as fund assets grow. It will also help ensure that the investment fund manager has assets available to satisfy any legal claims.

With respect to the question of capital adequacy, I note that Section 3.3 of the IOSCO Principles provides that "[the investment fund manager] should at all times maintain adequate financial resources to meet its investment business commitments and to withstand the risks to which its business is subject". My suggestions are aimed at satisfying this basic principle.

I recommend that part of the follow-on work arising out of my report focus on establishing what the minimum amount of regulatory capital should be and how it should be calculated. Consideration might also be given to whether any reduction in these amounts is appropriate where the services required by the manager of the investment fund are outsourced.

Seed Capital for Investment Funds

Most people that I talked to were in agreement that the minimum seed capital for investment funds should be raised but there was no consensus as to what the appropriate amount should be. It was suggested that if the effects of inflation on the dollar amount that was set many years ago were taken into account, the 1994 equivalent would be a minimum seed capital requirement of around $1 million and that perhaps this should be the amount. Other people approached the issue from the perspective of what was the minimum amount required in order to achieve sufficient portfolio diversification and others suggested simply placing limitations on investments that could be made until the capital raised from the public reached a specified amount.

Supra, note 53.

The subject of minimum seed capital for investment funds is discussed in this Section because of the impact that the recommendations with respect to it will have on minimum capital requirements for investment fund managers.

A further recommendation was made that the minimum seed capital to launch an investment fund should be set at $250,000 and that this capital should be permanent and subordinated to the public investors' capital in the fund. In addition, it was recommended that the seed capital invested in investment funds should not qualify as regulatory capital.

I endorse the recommendation to set the minimum seed capital for investment funds at $250,000 and to require that it be permanent and subordinated to the public investors' capital in the fund. The implementation of this recommendation should help align the investment fund manager's interests with those of the investors in the fund.

With respect to the suggestion that the investment fund manager's seed capital investments should not qualify as regulatory capital, I think this suggestion needs to be further considered before it is either adopted or rejected. I recommend that this be part of the follow-on work arising from this report. My thinking at this stage is that there is no reason why seed capital investments should be treated in a different manner from other capital of the investment fund manager that is subordinated.

Bonding and Insurance Requirements

Minimum bonding and insurance requirements should be established for investment fund managers. In order to do this there needs to be an analysis done of the insurable risks and the appropriate levels of coverage for these risks need to be determined. Among the risks identified by industry participants for inclusion are those related to errors and omissions, fidelity coverage, directors' and officers' insurance, property and casualty coverage and business interruption coverage.

I recommend that the analysis of the appropriate scope and levels of insurance coverage be undertaken as part of the follow-on work arising out of my recommendations.

I note that during the course of my discussions with industry participants, some people suggested that insurance is a "proxy for capital" and that if you had adequate insurance requirements, capital requirements could be lower. In asking others about whether they shared this perspective, a lot of people disagreed with the suggestion, as do I.

Internal Controls, Systems and Procedures

With respect to the need for an investment fund manager to have effective and efficient internal controls, systems and procedures, the determination of what is necessary in this respect should be the subject of the follow-on work in connection with this report. However, as a minimum, I recommend that investment fund managers should be required to:

- establish appropriate internal control procedures and a system for reporting on them;

- require its auditors to perform periodic reviews of the adequacy of the investment fund manager's internal control procedures and reporting requirements;

- establish appropriate procedures to ensure that monies that are required to be held in trust prior to being transferred to sponsored investment funds or to investors entitled thereto are in fact held in trust; this may be an area where reliance on CICA Section 5900 Reports may assist the investment fund manager and its auditors in determining the adequacy of the controls and procedures if third parties hold these funds; if CICA Section 5900 Reports are relied upon that have not previously been filed with the Securities Regulator, the reports should be required to be filed with the Securities Regulator;

- establish procedures designed to detect and report any money laundering activities;

- establish, and require any third parties that have been retained to provide services to or in respect of the investment fund manager and/or the investment funds sponsored by the investment fund manager to establish, adequate disaster

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The reference to "CICA Section 5900 Reports" refers to the accounting standards and recommendations set forth in Section 5900 of the Handbook of the Canadian Institute of Chartered Accountants concerning the circumstances in which an auditor may rely on audit reports prepared by another auditor with respect to internal controls and procedures of a third party where the auditor determines that these controls and procedures relate to aspects of the client's internal controls and procedures.

recovery systems to ensure that vital records are not lost in the event of disaster occurring.

I understand that as is the case in respect of investment dealers and other categories of dealers, investment fund managers are also working on identifying appropriate standards for disaster recovery procedures. This is an area that I recommend be reviewed by the CSA and opinions (supported by actual testing) be obtained as to the adequacy of the standards that are developed. I recommend that priority be given to this matter both by the industry and the CSA.

Monitoring Adequacy of Resources, Internal Controls, Systems and Procedures

There is a need to provide in the conditions for registration for monitoring and assessing the adequacy of the capital, human and technical resources referred to above and the internal controls, systems and procedures. Some assistance in determining what would be appropriate in this respect may be drawn from the initiatives of the federal government that were taken in 1992 to address concerns about the quality of management and corporate governance of financial institutions and which resulted in amendments to the Canada Deposit Insurance Corporation Act to enhance CDIC's powers with respect to such matters. Pursuant to these amendments, CDIC adopted by-laws requiring member institutions to abide by minimum policies and procedures to manage and control their risks prudently and released a series of standards of sound business and financial practices, known as "SARP" and hereinafter referred to as the "SARP Standards" which involve self-assessment review procedures. All deposit-taking institutions are required to demonstrate their compliance with the SARP Standards as a prerequisite to maintaining CDIC coverage and the CDIC by-laws set out the responsibilities of the boards of directors and of management in complying with the SARP Standards.

The SARP Standards take an objective approach rather than outlining detailed operating procedures but they are intended to be specific enough to identify emerging operational and managerial problems. ***The key to their effectiveness is that they establish the goals that proper operations and management should achieve while leaving the precise means of achieving these goals to each institution.***

The SARP Standards attempt to differentiate between the responsibilities of management and the responsibilities of directors with the intent of recognizing that:

(1) Management are responsible for:

(i) setting policies,

(ii) developing and implementing controls and procedures to manage and monitor risk exposures prudently, and

(iii) ensuring adherence to established policies and procedures, and

(2) Directors are responsible for ensuring that management adequately discharge their responsibilities for developing appropriate systems and processes to comply with the SARP Standards.

It is management's responsibility to demonstrate to directors (and to the regulators), on an on-going basis, that management are exercising the appropriate degree of prudence and conservatism in managing the enterprise. The directors are, however, ultimately responsible for ensuring the institution's compliance with the SARP Standards.

While the SARP Standards that have been developed for deposit-taking institutions may not be identical with what the standards of sound business and financial practices should be for an investment fund organization, I think that the concepts provide a good starting point for developing comparable ones for investment fund organizations and, in developing these standards, the investment fund industry should be able to benefit from the experience gained by the financial institutions in working with the SARP Standards and should be able to make appropriate adjustments that may be desirable.

It is therefore my recommendation that standards of sound business and financial practices for investment fund organizations that are comparable to the SARP Standards

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The information regarding CDIC's SARP Standards has been extracted from Deloitte & Touche's 1993 publication entitled "CDIC's Standards of Sound Business and Financial Practices - A Summary and Guidance for Directors and Management of Deposit-Taking Institutions".

that are required for federal financial institutions be developed for investment fund organizations and that this be done as part of the follow-on work arising out of this report.

Defective Systems and Procedures

With respect to systems and procedures, I am told that some people are building systems around defective practices. An example given to me referred to systems that are apparently being built to accept orders on floppy discs with there being nothing to prevent back-dating and pricing of orders.

In this respect, I understand that notwithstanding the forward pricing requirements of National Policy No. 39 and the plan of distribution that is set forth in an investment fund's prospectus, there is apparently a practice of back-dating trades and systems are being designed around this to accommodate back-dating and pricing of orders. I am told that some distributors are putting a lot of pressure on managers to allow back-dating of orders - which in effect means back-pricing for these orders. In this respect, I understand that managers are advised that if they do not accept an order on this basis, they will not get any future orders.

In my opinion, not only is this is an unacceptable sales practice that should not be allowed to continue, it is also an unacceptable business practice for a manager to agree to back-dating an order and to design an internal system that will accommodate it.

This is one of the internal controls that it should be expected that an investment fund manager would have in place to prevent such practices and that the external auditors would be reviewing in reporting on the adequacy of internal controls and procedures to meet regulatory requirements.

Settlement and Clearing System Participation

Investment fund managers should be required to participate in the settlement and clearing system referred to in Section 13.02.

Senior Management

In considering what human resources are required in order to function effectively as an investment fund manager, it was suggested that an investment fund manager should, as a minimum, be required to have a chief executive officer, a chief financial officer, a senior administrative officer and a senior compliance officer. Each of these persons should be required to have at least five years direct experience in the investment fund/securities industry or serving the industry from outside. The chief financial officer should be required to have suitable financial and accounting training and expertise to enable such officer to fulfil the functions of such office.

In situations where the investment fund manager is not providing investment advisory services directly to its sponsored investment funds but is retaining third parties to provide such services, the investment fund manager should be required to have on staff persons with sufficient knowledge, expertise and experience in portfolio management who will be responsible for oversight and assessment of the adequacy of the services provided by third party portfolio managers.

These suggestions appear reasonable and I recommend that they be adopted.

Board of Directors

With respect to the composition of the board of directors of an investment fund manager, it is my recommendation that the board of directors should consist of at least five people, a majority of whom are unrelated persons within the meaning of the term as used in the Dey Report. This requirement should apply regardless of whether the investment fund manager is a private or a public corporation.

Audit Committee

It should be mandatory that there be an audit committee of the board of directors of an

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Supra, note 51 .

investment fund manager regardless of whether the investment fund manager is a public or a private company. At least a majority of the directors on the audit committee should be "outside directors". It would be desirable that the chairman of the audit committee be a person with extensive financial and accounting expertise and experience and that such chairman be knowledgeable about the requirements in connection with financial statements for investment funds and about the other matters that impact upon them.

I recommend that further work be done with respect to specifying what the duties and responsibilities of the audit committee should be and what it is expected that the audit committee will do. One of the areas to be covered in this respect would be the involvement of the audit committee in being satisfied as to the adequacy of the internal controls and procedures. Some guidance with respect to the audit committee's responsibilities in connection with this matter may be drawn from the requirements that exist for audit committees of federal financial institutions and from the practices that have been developed by such audit committees and other audit committees.

The implementation of the recommendations made above under the heading "Monitoring Adequacy of Resources, Internal Controls, Systems and Procedures" with respect to adopting standards of sound business and financial practices for investment fund organizations will have an impact on: (i) the duties and responsibilities of the audit committee, and (ii) the type of audit reporting that is required. I anticipate that the details in this respect will be developed as part of the follow-on work arising from this report.

Exemptive Relief

Consideration needs to be given to the question of what provision there should be for the Securities Regulator to grant exemptive relief from any of the registration requirements for investment fund managers and what the parameters should be for the exercise of discretion to grant exemptive relief on the basis of being satisfied as to the equivalency of any matter with the minimum standards. I recommend that this be done as part of the follow-on work arising out of this report.

It was suggested that the current auditor's report that is required should be supplemented by an auditor's derivative report and/or the equivalent of the SEC's N-SAR Report.

Delegation of Functions

If the investment fund manager proposes to retain or cause the investment fund to retain third parties to provide all or any of the services that are required by the investment fund to carry on its operations, the investment fund manager should be required to satisfy itself, and to be able to demonstrate on an ongoing basis, that such party is and remains competent to fulfil the functions in question. This will require the investment fund manager to have a sufficiently detailed knowledge of the operating procedures of the third party to be able to meet its regulatory responsibilities and will likely mean that both its internal audit personnel and its external auditors will be involved in due diligence procedures in respect of these third party operating procedures. This may be an area where the CICA provisions respecting Section 5900 Reports may be of assistance in discharging some or all of the regulatory obligations of the investment fund manager in this respect.

The investment fund manager should have systems and procedures and personnel in place to monitor the services provided by third parties and the continued competency of such third party to provide the services.

The delegation of functions by the investment fund manager to third parties should not be permitted in any way to have an adverse impact on the sponsored investment funds and the investors in such funds. Accordingly, it should be a condition of any such delegation that the investment fund manager: (i) be responsible for the actions or omissions of any person to whom such functions are delegated, and (ii) should indemnify the investment fund for losses incurred by reason of such actions or omissions to the same extent that the investment fund manager would be liable to do so if the investment fund manager had itself committed the action or the omission to act giving rise to the liability.

Again, these requirements are reflected in the IOSCO Principles and they are aimed at ensuring that the investment fund manager has primary and overall responsibility for the proper management of the investment fund and that the investment fund manager's accountability is not diminished by the appointment of delegates.

14.02 In-House Services - Outsourced Services

During the course of my discussions with industry participants, I queried whether there was reason for regulatory concern about the degree of outsourcing of essential services for investment funds. I was advised that the negative aspects about outsourcing essential services relate to the fact that: (i) you are not assured of priority of service, (ii) you lose control over the adequacy of the systems and controls, the provision of the services, and the timing and accuracy of the processing, (iii) you do not have any control over the substantial cash flow - a $10 million dollar float is not unusual, and (iv) you do not have control over the quality of service.

I was advised that in the case of smaller funds that are "plain vanilla funds" where the services are provided by third parties, there is no inherently higher risk to investors caused by the outsourcing but the operating costs of such funds are generally higher and there are error costs.

I was advised that in the case of some industry participants who have brought the various services "in-house", such participants have been able to bring the costs of these services down and that service levels have improved, with error rates being dramatically reduced. The bringing of services "in-house" has required investment fund managers, who often were undercapitalized and understaffed, to make some major investments in their business operations. Those that have done so have told me that they think that bringing the services in-house has also tended to result in investors making a conscious choice to invest in their funds as opposed to simply being sold funds. They say that the ability to provide sophisticated in-house services is helping institutionalize the investment fund industry by providing a full-service financial institution within an investment fund framework.

These matters are primarily business matters. Accordingly, beyond the measures suggested in Section 14.01 that are aimed at requiring investment fund managers to have a substantial investment in their business and adequate human and technical resources, systems and procedures and the measures suggested in Section 14.03 relating to service providers, I think that the CSA should allow competitive forces to deal with the issues raised in the foregoing discussion of outsourcing.

14.03 Registration of Service Providers to Investment Funds and Others

Currently, there are no requirements that require firms that provide services to investment funds or to investment fund managers or to distributors of investment funds ("service providers") to be registered. These service providers include firms that perform registrar and transfer agency services, order entry services, order processing services, trustee services for registered retirement savings plans, registered retirement income funds and other tax-related plans, and administrative and custodial services for pre-authorized purchase plans, withdrawal plans and for other types of plans made available to investors by investment fund organizations.

Some of these organizations handle huge sums of money in respect of clients' funds in transit to or from the custodians of investment funds. Although, the services that these service providers perform are central to the integrity of the operations of the firms in respect of which the services are provided, these service providers are not subject to any regulatory oversight.

Recommendations

To remedy this matter, I recommend that:

Registration Requirements

There be registration requirements for these service providers that are comparable to the registration requirements for the firms to whom the services are provided. In this respect, if this would result in a service provider having to be registered with both the Securities Regulator and the SRO, provision should be made for only one registration to be required, with the conditions of registration being modified to take into account any additional conditions of registration that would be appropriate having regard to the scope of the activities of the service provider.

Periodic Audits

In addition, there should be a requirement for periodic CICA Section 5900 audits to be performed by the auditors of all service providers, with such audit reports being required to be filed with the Securities Regulator or the SRO, as applicable. It may be that these audits should be conducted more frequently than annually. I suggest that the question as to the frequency of these audits be considered as part of the follow-on work arising out of this report.

14.04 Code of Ethics and Business Conduct

Questions from time to time arise as to whether certain activities of an investment fund manager and of its directors, officers and employees and their respective associates and affiliates (all of whom are hereinafter collectively referred to as "investment personnel") may result in conflict with the investment fund manager's fiduciary obligations to its sponsored investment funds and the investors therein. Some of these questions relate to personal investment activities by investment personnel. Examples of personal investment activities that give rise to these questions include: (i) front-running, which occurs if a person engages in a securities transaction ahead of an investment fund with the expectation that the investment fund's transaction will have a favourable effect on the price of those securities, (ii) participating in hot issues where the expectation is that the securities will trade at a premium in the secondary market and may be disposed of at a profit without the purchaser being at risk, (iii) after-the-fact allocations of profitable investment fund trades to the personal account(s) of investment personnel, (iv) the receipt of substantial gifts from persons that do business with or on behalf of investment personnel, (v) serving on boards of directors of publicly-traded corporations, (vi) causing assets of an investment fund to be invested in an entity that employs or otherwise is associated with investment personnel or their friends or business associates, and (vii) causing an investment fund to make or retain an investment in an issuer in exchange for the issuer directing additional business to investment personnel.

While there are a variety of statutory and common law measures aimed at prohibiting transactions of the nature described above, confidence in the integrity of investment fund organizations would benefit by: (i) enhancing public awareness of and confidence in the measures adopted by investment fund organizations which have been designed to provide oversight of the personal investment activities of investment personnel, and (ii) generally

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Other areas where conflicts may arise are discussed in Section 19.

enhancing the ethical standards that are adhered to throughout the industry.

One measure which is aimed at contributing to these objectives would be to provide for each investment fund organization to adopt a code of ethics and business conduct that includes a policy with respect to personal investing by the investment fund organization and all other persons that are considered to be "investment personnel". It is important to note that many of the investment fund organizations in Canada currently have codes of ethics and business conduct. Compliance with these codes is viewed as integral to their operations and to the standards that they expect to be maintained by all investment personnel in carrying out their obligations in respect of sponsored investment funds. It is also important to note that in response to the recommendations made in the United States by the Investment Company Institute's special Advisory Group on Personal Investing in its report which was released on May 9, 1994 (the "ICI Report"), some Canadian investment fund organizations have already made changes in their codes of ethics and business conduct to reflect these recommendations.

Recommendations

It is my recommendation that:

(1) Investment fund managers, as a condition of their registration, should be required to adopt a code of ethics and business conduct setting out their policies, among other things, with respect to personal investing. If personal investing by investment personnel is permitted, the code should include provisions that reflect, as a

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The Advisory Group on Personal Investing was established early in 1994 by the Investment Company Institute in the United States to review the practices and standards governing personal investing and to make any recommendations deemed necessary or desirable in the interest of investors.

The Advisory Group on Personal Investing concluded that "an across-the-board prohibition on personal investing [would be] unnecessary, unfair and, in the final analysis, contrary to the interests of investors". However, notwithstanding this conclusion, the ICI Report recommended that all participants in the fund industry adopt certain policies and procedures governing personal investment activities of fund personnel, short of a total ban, designed to address "recognized potential for abuse". On June 30, 1994, the Board of Governors of the Investment Company Institute unanimously endorsed the conclusions and recommendations in the ICI Report and urged all ICI members, whose funds hold approximately 95 per cent of total US industry assets, to implement the recommendations by January 1, 1995.

minimum, the recommendations of the ICI Report.

If personal investing by investment personnel is permitted, the board of directors of an investment fund manager, as part of its responsibility to oversee the activities of the investment fund manager in respect of its obligations to the sponsored investment funds, should ensure that the code of ethics and business conduct contains comprehensive safeguards against abusive trading and conflicts of interest. Presumably, the board of directors of the investment fund manager, in determining the appropriate restrictions to place on personal investing, will consider whether to ban all personal transactions. If the decision is made not to do so, presumably the board will have received an explanation from management of the purpose that personal investing serves and will be satisfied that: (i) personal investing is not inconsistent with the investment manager's fiduciary obligations to its sponsored investment funds and the interests of investors therein, and (ii) the code of ethics and business conduct contains strict safeguards with respect thereto, reporting requirements and verification procedures.

I do not think that at the present time there is a need to specify a statutory code of ethics and business conduct that must be adhered to nor do I think it necessary at the present time to provide for additional investment restrictions or practices to be specified in policies, rules or regulations. Instead, each organization should be able to develop a code of ethics and business conduct that reflects the unique needs of its particular structure and relationships as long as the fundamental principles reflected by the recommendations contained in the ICI Report are adhered to and the provisions are designed to deal with the "recognized potential for abuse" referred to therein.

Industry participants have expressed concern about the practicality of enforcing compliance with a code of ethics that extends to as broad a category of "access persons" as the ICI Report recommendations contemplate. This concern should be addressed and I recommend that it be done as part of the follow-on work arising out of this report. In making this recommendation, I am not in any way suggesting that

The main recommendations of the ICI Report are set out in Schedule Two to this report.

the category of "access persons" should necessarily be narrowed but rather that it may be appropriate to consider whether pre-clearance procedures and reporting requirements should vary depending upon the relationship involved.

(2) Information about the policies of an investment fund organization with respect to personal investing by fund personnel and, where appropriate, other related parties, should be available to the public. Accordingly, the code of ethics and business conduct should be filed with the Securities Regulator and be available in the public file for review.

(3) There should be a requirement that the board of directors of the investment fund manager annually review the code of ethics and business conduct and compliance matters related thereto. One of the purposes of this review would be to enable the board to satisfy itself that personal investing, if permitted, continues to be desirable and not inconsistent with the duties of the investment fund manager and the interests of its sponsored investment funds and the investors therein.

(4) The scope of the code of ethics and business conduct should include all financial instruments whether or not they are "securities" within the meaning of securities legislation.

(5) Requirements comparable to the foregoing should apply to all persons who manage other people's money.

15. EDUCATION AND PROFICIENCY

Before discussing the matters relating to the establishment of investment funds (including how investment funds are structured and issues related to their governance) I want to outline my recommendations respecting enhancing the proficiency and training of industry participants and increasing the knowledge and awareness of investors with respect to investment matters.

I believe that a good part of the solution to many of the matters that are discussed in

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In addition, the prospectus disclosure documents should contain a brief description of the personal investing policies reflected in the code of ethics and business conduct.

Section 3 and which are presenting current challenges to the investment fund industry and the CSA, lies in improving the educational training and proficiency skills of the persons who are engaged in the various aspects of the investment funds industry and in improving the knowledge and awareness of investors with respect to investment matters. It is therefore my recommendation that efforts in this respect be a core regulatory strategy of the CSA.

15.01 Proficiency Requirements for Industry Participants

I believe that measures aimed at building the right knowledge and skills into the investment process at its very beginning should reduce the number of problem transactions that have to be dealt with by the Securities Regulator and should result in the Securities Regulator being able to deploy its resources more effectively. In addition, these measures should result in there being an increased level of confidence in the capital markets generally. This is the perspective from which I have approached the recommendations made in this Section.

In the course of discussions with industry participants and regulators about educational, proficiency and training requirements, comments were made to the effect that: (i) the current proficiency requirements that are contained in regulations to securities legislation and provide a blanket recognition to certain courses are out of date, and (ii) the regulations do not provide the securities regulators with the ability to require that the courses be upgraded or to suspend the recognition of the courses. I understand that some course providers do not consult with the CSA on the adequacy of the content or scope of these courses.

I believe that there is a need for the Securities Regulator, in conjunction with knowledgeable industry participants, to give more thought to what the proficiency requirements for registration should be and for the Securities Regulator to exercise more regulatory oversight over the content of the courses that are required to be completed in order to be registered to deal with the public. To the extent that statutory authorization is required for this, it should be sought.

At present, there are four courses available to mutual fund dealers and their sales representatives. These courses are provided by IFIC, The Canadian Securities Institute, The Institute of Canadian Bankers (which is offered to bank employees) and the Trust Companies Institute (which is offered to trust company employees). These courses differ in content, organization and approach. In the words of one of the course providers, the existing courses "have not been designed to meet any clearly articulated objective criteria and no benchmarking exists to measure whether the persons who successfully pass the courses have the necessary skills to provide the services that they are licensed to provide".

There is general acknowledgement by each sector of the industry that the respective courses could and should be improved. Both IFIC and The Institute of Canadian Bankers are involved in a major review and revision of their courses. The Trust Companies Institute and The Canadian Securities Institute are also making some revisions to their courses. A lot of work has been done and is continuing to be done by a lot of people in respect of each of the four courses.

What is of concern to me is that all of this work is proceeding without there having been an overall joint industry and regulatory evaluation of what the fundamental skills are that are required to function responsibly and effectively in today's environment. In an environment that is concentrating on building relationships with clients and the ability to provide overall financial planning advice as well as selection of product, it is essential that the perspective of the regulators and of the four separate course providers be broadened and coordinated.

15.02 Proposals for Enhancing Skills of Industry Participants

In talking with industry participants, it is clear that most of them have recognized the need to invest more resources into improving education and training and raising proficiency skills. The time is therefore right for re-assessing what the standards should be and for determining how to achieve these standards. The suggestion has been made, which I endorse, that a joint industry and regulatory task force be established to undertake this initiative. It will be important to have trained educators involved in this process as well as people who have a very practical understanding of what it is that registrants need to know to carry out their responsibilities. Among the matters that I recommend be addressed by the task force are the following:

The Need to Identify Requisite Skills

There is a need to identify the requisite skills for mutual fund (and other) dealers and their respective directors, officers, supervisory personnel and sales representatives and to design curriculum standards that will provide for these skills.

In determining what these skills are, there is a need to recognize the shift that has resulted in the provision of advisory services being regarded as the primary services that are being provided by persons who formerly regarded such advisory services as being incidental to the transactional services that they provided.

Accordingly, people need to be trained in a manner that will provide them with the necessary skills to sustain the broader-based advisory services. This may involve incorporating at least the rudiments of financial planning skills into the course, including knowledge of basic tax matters and property matters as well as increasing their awareness of when more expert help is needed.

My recommendations contemplate that educational, training and proficiency courses will continue to be offered separately by the four different course providers. However, in this respect, the ***number*** of course providers is not the focus of my comments. What I am focussing on is core curriculum standards to be reflected in any course, regardless of who is offering it, that is recognized by the Securities Regulator and/or SRO as satisfying minimum conditions for registration.

The Need for Objective Criteria and Common Core Requirements

There is a need to establish objective criteria (i.e. what skill level is expected upon successful completion of the course) with respect to the substantive matters to be covered by any course that is recognized by the Securities Regulator and/or the SRO as satisfying minimum conditions for registration.

There should be core requirements that are common to all courses that are recognized by the Securities Regulatory and/or the SRO as satisfying minimum conditions for registration, with provision for the addition of requirements designed to meet any unique needs of people who are employed by banks, trust companies or full service investment dealers.

The successful completion of the basic courses offered by the course providers should allow the sales representative to deal in a limited range of products (which range should be defined). The successful completion of additional courses should be required before a sales representative is permitted to deal in more complex products.

Teaching Methodology

It has been suggested that because people learn in different ways, the courses should be designed in a manner that will provide people with opportunities to learn in a variety of ways. I have been advised that higher retention rates often come from desk-top interactive learning or participation in a group learning project. I recommend that consideration be given to incorporating learning methodology of this nature into the training process.

It has also been suggested that part of the basic course requirements should include the requirement for a successful completion of a case study project that is designed to test the ability to apply the concepts covered in the courses in a practical manner with a view to assessing the level of understanding of the course material and the ability to apply it in a responsible manner.

The Need for Continuing Review of the Courses

There is a need to provide for a continuing review and revision of course content to keep pace with changes in the law, regulatory requirements and new products.

In addition, the review and revision of course content should focus on areas where there have been problems as evidenced by client complaints or regulatory action being taken. This would involve tracking the types of complaints that sales representatives and firms receive from clients and of regulatory action that has been taken with a view to adjusting course content to focus on or supplement areas that may be weak.

I note that based on looking through the materials provided to me by the course providers, I was left with the impression that all courses would benefit from a review of the information contained therein from the point of view of accuracy and adequacy. For example, even the explanation of something as basic as what a mutual fund is could be improved upon.

The Need to Provide for Specialized Training

There is a need for all courses to provide for specialized training of supervisory personnel including directors, officers, branch managers and assistant branch managers. Not all of the courses currently provide for this.

The Need to Focus on Ethical Business Conduct

Course content should include increased emphasis on: (i) business ethics, rules of fair conduct and business practices, (ii) the obligations of the mutual fund or other dealer and the sales representatives to their clients, and (iii) an awareness of conflict of interest situations generally. Practical examples need to be given and discussed in context.

The Need to Improve Awareness of Securities Regulatory Requirements

There is a need to improve the awareness of sales representatives and others of what the securities regulatory requirements are in respect of fundamental matters such as the obligation to deliver a prospectus and financial statements, order processing obligations, the segregation in trust and transmittal of funds, the maintenance of records and other similar matters. Learning how to comply with these requirements should be built into the learning process. The Canadian Securities Institute's Conduct and Practices Handbook should be a helpful starting point in this respect.

The Need to Improve Awareness of the Relevance of Disclosure Information

There is a need to improve the knowledge and awareness of sales representatives about what information is in the prospectus and in the continuous disclosure documentation. Sales representatives often do not regard these documents as having any relevance to them and as a result investors do not see them as having any relevance to their investment decisions. As a minimum, there is a need to train sales representatives to focus investors' attention on what information is contained in the documents.

The Need for a Common Examination

There is a need that there be a common examination with added segments for specialized knowledge required by bank and trust company employees. There is a need to establish an objective marking system.

The intention of this recommendation is to ensure that a common standard of core proficiency will be achieved regardless of which course is completed.

The examination should be structured and the marking system should be designed to test more than rote memory or to give credit for lucky guesses on multiple choice or true and false questions.

A case study or "application-type" question that requires the application of knowledge and professional judgment and principles should form part of the exam.

Currently, IFIC, The Institute of Canadian Bankers and The Trust Companies Institute have a common examination.

The Need to Develop Minimum Standards for In-House Training and Apprenticeship

There is a need to provide for a period of apprenticeship during and/or following the completion of the basic course in order to provide supplementary in-house training for sales representatives before they are able to deal with the public on their own. In this respect, minimum standards for in-house apprenticeship training should be developed. This training should take place either simultaneously with the completion of the basic training course or commence immediately thereafter. The purpose of this apprenticeship training is to provide the sales representative with the opportunity for real-time application of the principles learned during the completion of the basic course, under the direct supervision and review of the firm's experienced personnel before the sales representative is able to deal on his or her own with the public. With respect to the question about what the length of the apprenticeship period should be, it has been suggested that six months is long enough. I do not think that it should be shorter.

There should be a requirement during the apprenticeship period to complete additional courses successfully that deal with: (i) asset allocation and selection issues, (ii) know-your-client and suitability issues, and (iii) ethical sales issues, as these matters take on additional perspective and meaning with the benefit of practical experience in dealing with the application of the principles.

For an apprenticeship-training program of this nature to be successful, the compensation system of the dealer will need to be structured to compensate the "trainer(s)". In other words, the portion of the income generated by the sales representative that might ordinarily be allocated to the sales representative with respect to transactions effected during the apprenticeship-training period would likely not be allocated exclusively to the sales representative.

In making my recommendations for an apprenticeship-training program, I contemplate that this program would be part of firm-wide rigorous supervisory review standards designed to ensure that the firm is meeting customer needs and expectations. This type of program and supervisory review standards is essential in a business that is increasingly oriented towards establishing relationships with clients that are based on advisory services. In this respect, I note that the requirement for apprenticeship-training is an integral part of the training of any professional adviser. Examples include the articling programs for lawyers and accountants and the internship for members of the medical profession. The financial well-being of the public, in my opinion, merits a comparable program.

The Need to Develop a Mandatory Continuing Education Program

There is a need to develop a mandatory continuing education program designed to:

(i) bring all registrants up to the new skills level outlined above;

(ii) maintain and add to skills and keep abreast of new regulatory and self-regulatory requirements, new laws and new products;

(iii) reinforce, with the benefit of practical work experience, the basic courses designed to increase awareness of conflict of interest situations and of the requirement to adhere to high ethical standards and principles.

The costs of this continuing education program should not be passed on to investors through investment fund managers sponsoring educational conferences and trips.

Some people that I have talked to have questioned the need for a mandatory continuing education program. Other people consider it to be a necessary part of the need to keep abreast of developments in a knowledge-based industry that is continually changing.

My basic reason for recommending that there be mandatory continuing education is that if investors are going to rely on the advice of their sales representatives, the sales representatives need to be highly-trained and up-to-date.

15.03 Advisers and Financial Planners

Although the comments and recommendations in Sections 15.01 and 15.02 are focussed on the basic education courses, training and proficiency requirements for dealers, their directors, officers, sales representatives and employees, the underlying principles reflected in the comments and recommendations apply equally to education courses, training and proficiency requirements for other categories of registrants. In particular, the principles apply to those persons who propose to offer special advisory or financial planning services. In my opinion, it is essential in the public interest, that such persons not be permitted to offer such services until they have successfully completed courses designed to equip them with the requisite skills to sustain this activity and have been employed for at least five years working under the supervision of an adviser or financial planner, as the case may be, who has the requisite proficiency and experience requirements.

I recommend that the initiatives of the Quebec Securities Commission and of the Saskatchewan Securities Commission to require registration of financial planners and to prescribe proficiency and other requirements for them be supported in the context of there being national, uniform requirements in this respect that reflect the recommendations outlined in this report. I recommend that this be part of the follow-on work arising out of this report. To the extent that financial planners are "selling products" and are being compensated by the issuers of such products or by parties related to the issuers of such products (such as investment fund managers) they should be subject to the same requirements for registration and membership in the SRO as any other dealer and should be bound by the same rules of fair conduct and business practices that would bind a member of the SRO. The whole issue of the suitability of financial planners being compensated by the issuers of the products that are included in the financial plans they prepare for clients should be reviewed.

15.04 Investor Education

As noted above, I am recommending that efforts aimed at improving the knowledge and awareness of investors should be a core strategy of the CSA. I recommend that part of the follow-on work to be done as a result of this report address how this strategy should be implemented. It will be important to have trained educators involved in this process as well as people (including investors) who have a very practical understanding of what it is that investors need to know and want to know.

Investor education has become a marketing strategy of many industry participants including investment fund managers, investment fund distributors, banks, trust companies, full service investment dealers, financial planners, lawyers, accountants and individual sales representatives. While the desire to educate investors is basically a commendable one, the quality of the programs vary and investors often query whether the information that they get is self-serving. To a lesser extent, the same questions arise when the investor education programs are provided by industry-based organizations such as IFIC, the IDA and The Canadian Securities Institute. Even schools and community colleges become suspect when the courses they offer are taught by an industry participant.

Recommendations

The Need for Securities Regulator to Remain Involved

Because of the doubts about the objectivity of many of the investor education initiatives, it is important that the Securities Regulator remain involved in investor education initiatives while at the same time encouraging the SRO, IFIC, the IDA, CDIC, CIPF, The Canadian Securities Institute, The Institute of Canadian Bankers and the Trust Companies Institute to be proactive in investor education programs

The Need to Develop a Code of Standards and Ethics Regarding Investor Education

There is a need to develop a code of standards and ethics regarding investor education -what should be done and what should not be done. In addition, there is a need to provide some quality control over the programs that are offered by the various industry participants.

It has been suggested that before an industry participant should be allowed to offer an investor education seminar or course, the industry participant should be required successfully to complete a training course designed to enable the industry participant to comply with the abovementioned standards.

Input into School Curriculum

Some commenters have described Canadians as being "financial illiterates" and lacking in the basic knowledge and skills to comprehend information given to them. If this is true, to the extent that the problems are caused by the lack of basic literacy and numeracy skills, such problems are hopefully being addressed by those responsible for basic education needs.

To deal with the financial illiteracy aspect of the matter, I recommend that the Securities Regulator, either directly or through the organizations that are involved in offering proficiency courses to the investment fund industry, work with the appropriate governmental authorities to see if it is possible to build some basic financial knowledge and planning skills into existing school curricula.

For example, there is no reason why mathematics courses cannot include illustrations of the application of the mathematical principles that are being taught to such matters as: (i) explaining what compound interest is, (ii) how to calculate it, and (iii) how to relate this information to some real life examples, such as the effect that compounding interest has on a periodic savings program. There is no reason why elementary principles of planning and budgeting cannot be incorporated into the various life skills courses.

Assistance to Schools, Community Colleges and Universities

The Securities Regulator should participate in the development of courses and materials designed for investor education programs that are offered by schools in their night course programs, community colleges and universities and, to the extent feasible, provide persons to speak to these groups.

Materials should be available for use in a variety of ways - i.e. in written form, on computer disks, videos, electronic data feeds and slides and should include desk-top interactive learning aids.

Preparation of Investor Education Material

The CSA should consider enhancing its program of preparing investor education materials. To date, initiatives in this respect have been somewhat limited.

In addition to initiatives of this nature, consideration could perhaps be given to a newsletter type of document that would include advice to investors on topics that are chosen on the basis of the types of complaints that the enforcement branches of the CSA are receiving - a sort of "Investor Awareness Program". For example, many complaints received by the Enforcement Branch of the Ontario Securities Commission relate to people not being aware that a redemption charge would be made on the sale of their investment fund securities. A short, plain language article that alerts investors to the fact that there may be charges of this nature, what questions to ask, and where to look for the information could be helpful to make other potential investors aware of the matter. This is an activity that could be carried out by the SRO or by IFIC either alone or in conjunction with each other and the Securities Regulator.

A publication telling people what they should expect to receive when they have made an investment should also help enhance investor education. For example, some people do not know that they should expect to receive a confirmation of their order or an annual or an interim report or account statements. Some people do not know what the information in a confirmation statement means and they have trouble understanding their account statements. A publication guiding them through this information would be helpful.

These are simple matters but often people are too embarrassed to ask about them. This is the level at which knowledge and awareness needs to start - not at trying to teach arcane principles of investment theory.

Dissemination of Investor Education Materials

One of the concerns that the CSA has had with respect to investor education relates to how to reach the people who really need to know at a reasonable cost.

With the increased media interest in this area, it is not unreasonable to expect that materials of the nature described above, or at least the substance thereof, would be reproduced by the media. In addition, with the increase in the publication by industry participants of newsletters, it is not unreasonable to expect that the materials, or the substance thereof, would be reproduced in such newsletters.

The use of computer networks such as the Internet is also a means that would result in broad dissemination of information at nominal cost.

Simplifying Primary and Continuous Disclosure Requirements

Simplifying the way that disclosure documents are required to be written and allowing them to be presented in a way that makes them inviting to be used as marketing and educational tools would increase the likelihood that the documents will be regarded by both the sales representatives and their clients as useful and relevant. This would improve the likelihood that the documents will be read and of the knowledge levels of both sales representatives and their clients being increased. Additional recommendations in this respect are dealt with in the recommendations concerning improvements to the disclosure system which are contained in Section 17.

I note the recent initiatives of the SEC that are aimed at better informing investors which were outlined by Arthur Levitt, the Chairman of the SEC, in a recent speech where he advised investors that the SEC is doing more every day to forge a partnership with investors. Among the initiatives that he referred to in this respect are: (I) the creation of an SEC Consumer Affairs Advisory Committee to advise the SEC on the issues facing the public in their markets, (ii) the restructuring of the SEC's Consumer Affairs Office, which includes a new toll-free Consumer Information Line whereby callers will be able to get answers to commonly asked questions from a series of easy to use menus, (iii) the provision of information through a system accessible through the Internet or by direct dial, with respect to SEC investment alerts, consumer brochures, policy announcements and rule proposals that are available 24 hours a day, (iv) the preparation and release of a new SEC brochure about mutual funds, and (v) "town hall" meetings such as the one at which the abovementioned speech was made.

16. THE ROLE OF IFIC

Consumer Protection: Tips from an SEC Insider" - Remarks by Arthur Levitt, Chairman, US Securities and Exchange Commission, Albuquerque, New Mexico, December 16, 1994.

During the last few months a lot of consideration has been given to the possibility of IFIC (whose membership includes both the mutual fund managers and the mutual fund distributors) becoming recognized as the self-regulatory organization to regulate the investment fund industry. IFIC has publicly acknowledged its willingness to assume this function and has been considering alternative ways in which it might do so. Its willingness to assume responsibility and leadership in this respect is commendable.

However, in today's environment, with every facet of the investment fund industry facing distribution challenges, I believe that it will be very difficult, if not impossible, for IFIC to become the self-regulatory organization of the investment fund industry. In this respect, not only are there the normal tensions that exist between "managers" and "distributors" to overcome, there are also the tensions that result from the division of the "distributors" into those that are regulated as members of the IDA and/or a stock exchange ("SRO Members") and those that are not. With respect to the distributors that are not SRO Members, there is yet a further division between those that are subsidiaries of a regulated financial institution and those that are not - i.e. the mutual fund specialists or "financial planners". There is a wide divergence of views among these different categories of distributors as well as a wide divergence of practices, standards and capital resources.

The mutual fund specialists or "financial planners" are a major component of the distribution network that is available to the independent mutual fund management organizations. I am told that if IFIC management or the IFIC Board or an IFIC member should attempt to advocate or implement measures that are aimed at raising standards to those to which SRO Members must adhere, the mutual fund specialists and "financial planners" simply will no longer act as distributors for the investment funds sponsored by the relevant mutual fund managers. Whether this is the case or not is not the issue. The issue is the perception that this is or might be the case. In my opinion, this is not the right environment for the creation of the strong, independent, effective SRO that will operate on a national basis that is contemplated in Section 9.02.

For the reasons outlined in Section 9, I think it is important to eliminate the substantial differences between the degree of regulation and controls that apply to the various categories of distributors. The principles of financial responsibility, fair conduct and sound business practices should apply regardless of who is selling the securities or what securities are being sold. I also do not think that it would be appropriate to have a self-regulatory organization or organizations that would regulate the activities of its members only insofar as they relate to the sale of investment funds to the public. This type of fragmentation of regulation would result in an artificial division of activities, needless duplication of regulatory requirements, the risk that some activities might fall through the cracks and put the member organizations, their affiliates and the public at financial risk, and would be very costly. Accordingly, I think that both the industry and the public would be better served by an SRO of the nature described in Section 9 and that IFIC should not seek to regulate the distributors of investment fund securities.

It is my recommendation that IFIC's role be modelled on that of the Investment Company Institute in the United States. The Investment Company Institute has served very effectively as an advocate of investment fund interests and has taken a pro-active role in all aspects of investment fund regulation. IFIC would be better positioned to do the same if it were not subject to pressures brought to bear by the distribution side of its membership.

17. THE DISCLOSURE SYSTEM

As noted in Section 12, securities regulation in Canada is founded on the fundamental principles of: (i) registration of persons who are permitted to deal with the public, and (ii) disclosure of material facts about issuers. The disclosure system, as is the case with the registration system, is not working as effectively as it should.

As noted in Section 15.02**,** In the case of the investment fund industry, a large part of the problem is that the disclosure documents are not seen by the distributors (i.e. the investment dealers, the mutual fund and other dealers and their respective sales representatives) as being relevant or meaningful to investors. Many of them question why a prospectus should be required to be delivered to investors, arguing that there is no reason to treat investment fund securities any differently than other securities that are traded in the secondary market.

Distributors find the current system that requires the delivery of the simplified prospectus with the separate annual and interim financial statements to be cumbersome. They often do not have all of the required documents in stock and in many cases the documents that are in stock are not the most current ones. They complain about having to carry a lot of materials with them when they call on clients. They say that people do not want these documents and that they do not want the annual and interim reports that are mailed to them once they become investors in an investment fund. They say that investors do not find these documents meaningful or relevant. The costs of all of this disclosure are high and are ultimately borne by investors.

Like it or not, this is the reality that securities regulators have to deal with. The challenge is how to remedy the situation, particularly when disclosure and consent is the basis on which securities regulators have allowed industry participants to engage in transactions where there is a conflict of interest between the industry participant and the investors in the fund. The efficacy of the disclosure and consent strategy is called into question by the reality that the documents containing the relevant information are not being delivered to investors or, if they are delivered, they are not being read and understood by investors. Among other concerns, this poses potential liability issues for industry participants. The continuation of the current regime is inconsistent with the effective and efficient operation of the capital markets.

Studies that have been done show that people do want much of the information that is contained in the prospectus. The problem is that investors have not recognized that this information is in the prospectus. Often no one has ever sat down with an investor and reviewed with the investor what information is in the prospectus and how to find or use it. The documentation is intimidating to many people, particularly those who are not accustomed to reading as their medium of choice for information gathering. Even the name of the information document creates a problem. The word "prospectus" is not part of the ordinary person's daily vocabulary. A lot of people do not know what the word means and it does not occur to them to look behind such label for useful information.

There are some lessons about disclosure to be learned from the immense popularity that performance information enjoys right now with investors. The attention of investors has been focussed on this information because it has been made so readily available in a

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My comments concerning performance information are contained in Section 24.

variety of ways and it has caught their interest. People want to know more about performance and are subscribing to a variety of services that make this information available on computer discs and otherwise. Portfolio analytics has become a growth industry and concepts such as duration, standard deviation, beta and the Sharpe Ratio are becoming part of ordinary marketing communications to investors because people want this information.

Accordingly, my recommendation to the CSA is not to abandon disclosure as a regulatory strategy but rather to concentrate on making disclosure relevant, meaningful, easily identifiable and readily accessible.

17.01 Framework for a Different Approach to the Disclosure System

With these goals in mind, I am suggesting that a different approach to disclosure be taken, utilizing the elements of the present disclosure system. This approach involves having:

(i) a basic investor education document (which will not form part of the "prospectus"), details of which are outlined in Section 17.02;

(ii) a base information disclosure document, the filing of which will establish the investment fund as a reporting issuer (the "base disclosure document"), details of which are outlined in Section 17.03;

(iii) the current continuous disclosure documents that are required to be provided to investors and filed with the securities regulatory authorities by reporting issuers, with the addition of some enhanced reporting requirements, details of which are outlined in Section 17.04;

(iv) a point of sale information disclosure document (the "point of sale disclosure document") that incorporates by reference the documents referred to in clauses (ii) and (iii) above, details of which are outlined in Section 17.05.

The base disclosure document, the current continuous disclosure documents and the point of sale disclosure document together will form the "prospectus" and will be the basis for statutory liability in the event of a misrepresentation.

The approach that I am suggesting contemplates that each investment fund that proposes to offer its securities for sale to the public on a continuous basis would be required to be initially qualified for sale to the public on a continuous basis. In this respect, a base disclosure document would be required to be filed with the Securities Regulator. Upon the issuance of the filing receipt for the base disclosure document, the investment fund would become a reporting issuer and its securities could then be offered for sale to the public on a continuous basis through registrants. As is the case with respect to all reporting issuers, the investment fund would be subject to compliance with the continuous disclosure obligations of a reporting issuer, with some enhancements as discussed in Section 17.04. The base disclosure document would be required to be refiled every three years, subject to the ability of the Securities Regulator to require more or less frequent refiling depending on what changes have occurred in the information pertaining to the investment fund.

17.02 The Basic Education Document for Investors

I recommend that a basic education document for investors in investment funds be prepared that would be:

(i) industry generic, and

(ii) written in a simple, plain language style.

This document would explain what an investment fund is, how it works and the basic regulatory requirements that affect all investment funds. The inclusion of this information in this document would eliminate the need to repeat it in either the base disclosure document, the continuous disclosure documents or the point of sale disclosure document.

Contents of the Basic Education Document for Investors

In addition to explaining what an investment fund is, how it works and the basic regulatory requirements that affect all investment funds, the basic education document would tell investors what they should expect to receive after they place their order for the purchase or sale of investment fund securities. It would contain samples of confirmations and other standard forms with an explanation of how to read them and what to do if the investor does not receive them or has questions. It would explain that current valuations of investment funds are published in the newspapers and would explain what the information that is given is.

The basic education document would contain:

(i) a glossary of the commonly used terms to assist investors in understanding the information contained in the basic education document as well as in the other disclosure documents;

(ii) basic information for the investor about how to set financial goals, determine the investor's tolerance for risk and set investment objectives so that these can be matched against proposed investments;

(iii) generic tax information about income and capital gains distributions and capital gains (or losses) on the disposition of securities;

(iv) generic information about registered retirement savings plans, registered retirement income funds and other plans that are commonly offered by investment funds and an explanation that income tax is required to be withheld on registered plans in the event of early termination.

Delivery of the Basic Education Document for Investors

The basic education document for investors would be required to be given to each investor by the sales representative at the earliest opportunity during the sales representative's initial meeting with the investor and in any event no later than the time that the investor's order is taken. The intention of this recommendation is to provide the investor with the opportunity to have the benefit of the information contained in the basic education document as early as possible in the process of the investor making his or her investment decision. In the case of existing investors, the basic education document would be required to be included with the next statement sent to the investor after the document is available.

In addition to being available in written form, it would be desirable for the basic education document to be made available on audio tapes, audio-video tapes, computer discs and through computer network systems such as the Internet.

The basic education document could also be made available in schools, libraries and in various offices including the offices of the Securities Regulator, the CSA, the SRO and IFIC.

Preparation of the Basic Education Document for Investors

The basic education document for investors should be prepared with the input of the industry and the regulators.

There should be a procedure for periodically reviewing and updating the information contained in the basic education document.

17.03 The Base Disclosure Document

The base disclosure document (which is the base document that would be required in order to initially qualify an investment fund for sale to the public on a continuous basis) would be required to include full, true and plain disclosure of all material facts relating to the investment fund and to the offering and sale of its securities. This should be a user-friendly document, simply written, without duplication of information that is required. If a question and answer format is desired to be used by the investment fund, it should be permitted to do so. Some people have suggested adopting a standard format so that it would be easier to compare one investment fund to another. I do not think that this should be mandated because it introduces an unnecessary level of rigidity to the system.

Basically, the information that is required by National Policy No. 36 to be contained in the simplified prospectus and in the annual information form would be required to be contained (without duplication) in the base disclosure document. Information which is generic to all investment funds would be eliminated from the disclosure requirements for the base disclosure document because it would be included in the basic education document for investors which is described in Section 17.02. If there is any variation between the generic information that is included in the basic education document for investors and the information that pertains to a particular investment fund, this difference would have to be disclosed together with an explanation for the variation and its implications for investors.

In conjunction with the filing of the base disclosure document, the proposed point of sale disclosure document together with the audited financial statements of the investment fund and, all material contracts, (including third-party service contracts and "ordinary course of business" contracts that are entered into with related parties or which relate to the functions of the investment fund), would have to be filed with the Securities Regulator for review. The present procedure for filing a preliminary and then a final prospectus would apply to the filing of the base disclosure document.

The material filed with the Securities Regulator would be subject to an in-depth review with respect to the adequacy of the disclosure and the acceptability of the provisions contained in the documents from the perspective of ensuring the integrity of the product and the protection of investors. When the Securities Regulator is satisfied with the material that has been filed, a filing receipt would be issued.

Amendments to the Base Disclosure Document

If a material change with respect to the investment fund occurs that is subject to the control of the investment fund and/or its manager, an amendment to the base disclosure document would be required to be filed with the Securities Regulator and accepted by it for filing before the material change could become effective. An example of a material change of this nature would be a voluntary change of the manager of the investment fund.

If a material change with respect to the investment fund occurs that is not subject to the control of the investment fund and/or its manager, an amendment to the base disclosure document would be required to be filed with the Securities Regulator. If it should appear to the Securities Regulator that the material change would impair the integrity of the product or investor protection, the Securities Regulator should have the power to take appropriate action to protect investors including powers to: (i) require the investment fund to take appropriate action to remedy the concerns, (ii) require that investor approval be obtained for the continuation of the investment fund, and/or (iii) suspend the issuance and redemption of securities pending rectification of the concerns or winding up. Normal provisions contained in securities legislation relating to time delays and giving people an opportunity to be heard would apply.

Definitions of Material Change and Material Facts

There is a need to develop suitable definitions of the terms "material change" and "material facts" as used in the context of an investment fund because the definitions of these terms in current securities legislation generally do not work in the case of investment funds. In this respect, the current definition of "material change" relates to changes in the business, operations or capital of the issuer that would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer. The current definition of "material fact" refers to a fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities.

In the case of an investment fund, its assets consist of marketable securities and the securities issued by the investment fund are valued at the net asset value of these marketable securities - i.e. the market value of the assets of the investment fund less the liabilities of the investment fund. It is therefore unlikely that the market price or value of the securities of an investment fund will be affected by any change in the business, operations or capital of the investment fund.

Accordingly, the definition of what should be considered to be a "material change" in relation to the affairs of an issuer that is an investment fund needs to be defined in a manner that is not based on the change having a significant effect on the market price or value of the securities of the investment fund. Examples of changes that might be considered to be material changes in the case of an investment fund include a change in the portfolio manager of an investment fund, a change in the fundamental investment objectives of an investment fund, a merger of one investment fund with another, a change in the risk profile of an investment fund, and certain changes in fundamental contracts.

Changes to Fundamental Contracts

Changes to fundamental contracts (whether they occur as a result of amendments, cancellations or the entering into of new fundamental contracts) would be required to be filed with the Securities Regulator and accepted for filing prior to the changes becoming effective.

Refiling of the Base Disclosure Document

The reasons for recommending the somewhat stringent requirements with respect to amendments to the base disclosure document and to fundamental contracts relate to: (i) the need to improve the timeliness of making the information relating to these amendments and proposed amendments available to securityholders and to potential new investors, and (ii) the fact that I am recommending that the present requirement to refile a prospectus every year be relaxed.

In this respect, I recommend that the base disclosure document be required to be refiled every three years, with the Securities Regulator having the power, if deemed appropriate, to waive the refiling requirement.

An investment fund may elect to refile the base disclosure document sooner if there have been a lot of changes and it is desired to consolidate all information in a new base information document.

The Securities Regulator may require the base disclosure document to be refiled sooner than every three years if there have been a lot of changes and it is deemed desirable that all information be consolidated in a new base information document.

17.04 Continuous Disclosure Requirements

It is my recommendation that the timely disclosure provisions contained in current securities legislation and national policies would apply to investment funds once they become reporting issuers, with the result that timely and public disclosure of material changes would be required.

As noted in Section 17.03, it will be necessary to develop definitions of the terms "material changes" and "material facts" in relation to investment funds. It would be desirable at the same time to harmonize the timely disclosure requirements that are contained in securities legislation with those that are contained in national policies.

Material Change Reports

I recommend that in addition to an investment fund being required to file material change reports with the Securities Regulator and to issue press releases, it should be required to advise securityholders of the material changes.

Generally speaking, the nature of the material change should determine whether a separate mailing is required in this respect or whether it is sufficient to include the information with the next general mailing to securityholders.

In cases where the material change is subject to the control of the investment fund or its manager, the material change should not become effective until the expiry of a specified time delay after notice of the material change has been given to the securityholders. This would give investors who have concerns about the nature of the change - for example, an increase in fees or a change of managers or a change of investment objective - an opportunity to withdraw from the investment fund before the change becomes effective. As noted in Section 27.09, there should be no deferred sales charges, redemption fees or other charges made to investors who withdraw in these circumstances. If these fundamental changes are made within a relatively short period from the time when the investor acquired securities of the investment fund - for example, one year - provision should be made for the sales charges, transaction fees, administration and other fees and expenses that the investor has paid to be refunded to the investor.

Annual Reports

I recommend that the annual report of an investment fund be required to contain a discussion and analysis by management of the operations of the investment fund. The type of information that would be included in this management discussion and analysis ("MD&A") is the type of information that I believe investors, analysts and the media are looking for but cannot find in the documentation that is currently in use.

I think that the fact that this information is not readily available is one of the contributing factors to the increased and misplaced emphasis on short-term performance information. Short term performance information (with the corresponding performance information for the longer periods) is basically the only information that is out there.

I suggest that with the maturing of the investment fund industry and the advent of investment funds as market forces in their own right, it is time that the disclosure requirements concerning their operations be comparable with the disclosure requirements concerning the operations of other reporting issuers. However, because the operations of investment funds differ in many respects from the operations of industrial issuers, it will be necessary to develop MD&A disclosure requirements that are relevant to the operations of an investment fund.

The objective of the current MD& A disclosure policy is to give securityholders the ability to look at the issuer through the eyes of its management. With this objective in mind and using the current MD&A requirements as a guide, it should be relatively easy to develop the corresponding requirements for MD&A in the case of an investment fund. I suggest that this be part of the follow-on work resulting from this report.

To assist in understanding what I have in mind that would be included in MD&A for investment funds, I am listing some matters, which are meant as examples rather than as a definitive list of items, that might be included in MD&A disclosure:

(1) information regarding portfolio management strategies, including who is managing the investment portfolio, how they are doing it, any changes that have been made in this respect, the performance of the investment fund in relation to any performance goals that have been set for the portfolio manager, the risk profile of the fund and variances from it;

(2) discussion of the investment fund's performance for the current year in comparison with the prior year's performance, focussed on the total return of the fund, including income/loss by type (dividends, interest) and realized and unrealized capital gains/losses both on a per unit basis and in the aggregate;

(3) comparison of the investment fund's performance with relevant benchmarks and an explanation why the benchmarks that have been chosen are appropriate; in this respect, the measurement basis for the investment fund's performance should be consistent with that used elsewhere, particularly in advertising material;

(4) discussion and analysis of expenses with the significant components of expenses being highlighted and compared to the previous year with an analysis of changes; a discussion of the relevant provisions in the agreements in respect of the investment fund that govern what expenses may be charged to the investment fund

and how they relate to the actual amount charged to the investment fund should be included;

(5) discussion, to the extent applicable, of known trends, commitments, events and uncertainties that are reasonably expected to affect investment fund performance should be addressed; the general macroeconomic analysis addressing global interest rates, currencies and the economic performance of countries that is often currently included in annual reports should be consistently related back to historical fund performance and anticipated performance in the future;

(6) a comparative analysis of the composition of the year-end investment portfolio and changes in portfolio mix from year to year perhaps on a geographical basis and also by type of security;

(7) a discussion of how the investment portfolio composition relates to the investment fund's disclosed investment objectives; in this respect, plain language rather than jargon should be used to explain what is meant;

(8) if the investment fund invests in derivatives, a discussion of the strategy used;

(9) if the investment fund holds: (i) illiquid securities, or (ii) securities of companies in emerging markets where liquidity risk may exist, or (iii) large blocks of securities of other issuers where it would be difficult to dispose of the block at the market value attributed to the securities, this should be discussed;

(10) a discussion of the number of securities of the investment fund that have been sold and redeemed with an analysis of changes from the previous year; unusual trends such as a high level of net redemptions should be discussed and the implication to the investment fund explained; the implications of a high level of sales should also be discussed (e.g. is the fund so large that it cannot manage its portfolio trading readily or anonymously); future intentions with respect to sales and redemptions of

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See Section 25.05 for additional information about derivatives that should be included with the financial statements of an investment fund.

securities should also be discussed, including any actions the manager is taking to affect the number of securities that are outstanding;

(11) a discussion of the supervisory and compliance procedures that are in place to ensure conformity of transactions with: (i) the investment objectives, policies and restrictions of the investment fund, (ii) the provisions of the material contracts in respect of the investment fund, and (iii) the standard requirements regarding investment funds referred to in the basic education document for investors; if there have been any breaches in respect of these matters, the action that has been taken to remedy them and to guard against re-occurrence should be outlined;

(12) a discussion about how portfolio transactions for the investment fund have been handled including information about any principal broker with the comparative information that is currently required to be included under National Policy No. 36;

(13) disclosure of related party transactions as more particularly outlined in Section 19.

Interim Reports

I recommend that the interim reports be required to update the MD&A contained in the annual report or the latest interim report, as the case may be.

With respect to the frequency of interim reports, there has been some discussion about whether investment funds should be required to prepare interim reports on a quarterly basis. Some industry participants think that this should be mandated while others recommend that no change be made to the current requirement that requires only a semi-annual report to be prepared.

I recommend that no change be made to the current requirement for semi-annual reporting except in the case of investment funds that engage in related party transactions. In the case of such investment funds, I think that more frequent disclosure should be made in respect of related party transactions. I recommend that these investment funds be

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See Section 19.

required to deliver and file interim reports on a quarterly basis.

Disclosure in Annual and Interim Reports - Related Party Transactions

I recommend that investment funds that engage in related party transactions be required to include in their annual and interim reports enhanced disclosure regarding these transactions. This information should be required to be prominently displayed under a specific heading designed to direct the reader's attention to it such as "Related Party Transactions". In some cases, the information should be permitted to be given in summary form in the annual and interim reports. However, full details should have to be filed with the Securities Regulator with a certificate(s) signed by management and the directors of the manager as to compliance with the conditions on which the related party transactions were permitted under applicable securities legislation or exemptive relief to be carried out and by the independent board as to their periodic review of this matter, all as more particularly outlined in Section 19. The annual and interim reports should make reference to this filing and that the information is available for review in the public file or upon request from the manager.

Certificates in Annual and Interim Reports

The information contained in the annual and interim reports should be reviewed by the board of directors of the manager of the investment fund and by any board of the investment fund. Appropriate certificates, signed by management and the aforesaid boards should be included.

Time Delays for Delivering and Filing Annual and Interim Reports

A number of people with whom I spoke raised concerns about the length of time it takes to receive year-end and interim reports and recommended that the time delays for delivering and filing these reports be shortened. In recommending shortening the time delays for delivering and filing these reports, reference was made to the fact that the equivalent time delays in the United States are 60 days in the case of both the annual and the interim reports.

See Section 19 for particulars of the suggested enhanced disclosure information concerning related party transactions.

It is my recommendation that annual reports be required to be delivered and filed within 60 days of the end of the fiscal year of the investment fund and that interim reports be required to be delivered and filed within 45 days of the end of the relevant interim period. I understand that the time delays that I have suggested are realistic and that they address the need for more timely information being provided.

Auditors' Consents

The current requirements for the filing of auditors' consents would be satisfied by requiring that they accompany the annual financial statements that are filed with the Securities Regulator.

Delivery of Annual and Interim Reports to Securityholders

A number of investment fund managers with whom I spoke expressed concern about the inability to deliver annual and interim reports to securityholders of their sponsored investment funds whose securities were registered in the name of an investment dealer, mutual fund dealer or other category of dealer or in nominee accounts for such dealers.

Investment fund managers are concerned that the information disclosed in their disclosure documents is not reaching these securityholders. On the other hand, the various dealers do not want anyone else to have access to their clients and they say that their clients do not want the information that is provided. This problem is not unique to issuers that are investment funds. However, the ramifications in the case of investment funds may be greater because of the way investment funds are sold, the frequency of the transactions where periodic purchase plans are involved, the tendency by at least some dealers to treat investment fund sales as "off book", with the corresponding inability of the dealer to monitor transactions in investment fund securities that are being effected for clients by sales representatives and the opportunities that exist for misappropriating client funds.
The issues involved in this problem are complex and I am not going to attempt to discuss them in this report because they extend beyond the scope of the report. However, I think there are some changes that should be made in the case of securityholders of investment

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Supra, note 49. Also see Section 13.05.

funds and these are discussed in the following recommendations.

Direct Mailing of Annual and Interim and Material Change Reports

Investment fund managers currently provide securityholders whose investment fund securities are registered in the name of a dealer or in the name of a nominee of the dealer directly with the information that they require for tax purposes, using "secondary addresses" that have been provided to the investment fund managers for this purpose.

It is my recommendation that in addition to being able to use such addresses in order to provide tax information directly to securityholders, the investment fund manager should be permitted to use such addresses for the purpose of delivering annual and interim reports and material change reports.

Arrangements should be made for securityholders to request that not more than one copy of the relevant material be sent regardless of how many separate accounts the securityholder or members of the securityholder's family at the same address may have.

Explanation to Investors of the Relevance and Use of Disclosure Information

The relevance and use of the disclosure material to investors should be explained in the basic education document referred to in Section 17.02 and in the other measures recommended in Section 15.04 aimed at increasing the knowledge and awareness of investors.

Ultimately, if an investor does not want the disclosure material, the investor should be able to request that it not be delivered.

Compliance Actions

The SRO and the Securities Regulator should take the appropriate actions to require the rules that require all transactions to be recorded on the books of the registrant to be complied with.

17.05 Point of Sale Disclosure Document

It is my recommendation that a point of sale disclosure document, together with the base disclosure document for investors, be required to be delivered to the investor no later than the time that the order is taken.

The two documents need not be delivered together. If they have previously been delivered and no change has occurred in the information contained in the respective documents, they need not be redelivered to investors. The obligation to deliver the documents should be on the distributor. Provision will have to be made for delivering an updated point of sale disclosure document to investors who purchase investment fund securities under a periodic purchase plan.

Criteria for the Point of Sale Disclosure Document

The point of sale disclosure document should be kept short and should be written in a plain and simple style. It would be desirable to develop a standard format for this document to assist investors in being able to compare different investment funds. It is my recommendation that there be a separate point of sale disclosure document for each investment fund as opposed to one document covering several investment funds that are under common management.

Neither the current simplified prospectus nor any of the so-called point of sale disclosure documents that are currently in use or that are being developed and have been shown to me as proposed formats for this document conforms with what I am recommending be used.

What I have in mind is a document that would look more like a Morningstar report or a Bell Charts report in terms of the ability to condense meaningful information but would include the information referred to below under the heading "Contents of the Point of Sale Disclosure Document". In referring to the Morningstar and Bell Charts reports, I am only doing so to provide an example of the format that a point of sale disclosure document of

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A sample of the Morningstar report and of the Bell Charts report is included in Schedule Three to this report.

the nature that I am contemplating might take as it seems to be one that appeals to investors. In doing so, I am not endorsing the inclusion of all of the information that is contained in the Morningstar or Bell Charts reports nor am I suggesting that there should be a "rating" of investment funds. It is worth noting, however, that John C. Bogle, the Chairman of the Vanguard Group of investment companies, has stated that:

> "Morningstar provides nearly everything you need to know about specific mutual funds. Information that is not presented on a fund's page in Morningstar is probably not worth knowing".

The only reservation that I have with the format used by Morningstar is the fact that it is difficult to read. I recommend that larger type be required to be used even if this means that the information will not fit on one page.

Needless to say, if the information contained in the point of sale disclosure document is derived from the analytical work of others, the use of such information will require appropriate acknowledgements and/or agreements to be entered into with such persons.

Updating the Point of Sale Disclosure Document

The nature of the information to be contained in the point of sale disclosure document will require that the information that is contained in the point of sale disclosure document be updated on a periodic basis. In this respect, by reason of the fact that performance information will be permitted to be included, the information will be required to be updated as frequently as quarterly if the investment fund prepares interim reports on a quarterly basis.

Accordingly, the format should be such that updating can be easily done and the updated document be made readily available. Technology that allows this to be done is available and is in common use, as is evidenced by the work that is done by Bell Charts,

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Bogle, John C., *Bogle on Mutual Funds - New Perspectives for the Intelligent Investor,* Richard D. Irwin, Inc., 1994 - at page 154. Mr. Bogle goes on, however, to note some exceptions to the above statement (which are not relevant in the context of this report).

Morningstar and others.

Sales representatives, instead of carrying a lot of paper around, would have the information they need on a "read-only" computer disk, that would be replaced on an appropriate periodic basis and which would enable them to print out the point of sale disclosure document on an as-needed basis. Undoubtedly, there is other technology that would facilitate what I am suggesting.

Central Electronic Filing Facility

From the regulatory and compliance point of view, there will be a need for investment fund managers, distributors and regulators to have a record of the point of sale disclosure document that has been authorized for use at any time.

To deal with this need, I suggest the development of a central electronic filing facility to keep track of the various versions of the point of sale disclosure document and the relevant period of their currency. Copies of the documents could be retrieved on an as-needed basis and for evidentiary purposes they would be regarded as being original documents. The entry of these documents into the central electronic filing facility would be the equivalent of filing the documents with the Securities Regulator.

It is not unreasonable to expect that the investment fund industry would see fit to arrange for a service of this nature to be provided as ancillary to a service that will collect and process the data required to be contained in the point of sale disclosure document. Any such service provider would have to establish appropriate internal procedures and controls to ensure the integrity of its systems and of the data.

Contents of the Point of Sale Disclosure Document

I propose that there be two parts to the point of sale disclosure document. The first part would be provided by or on behalf of the investment fund to the distributor. The second part would be provided by the distributor who would be responsible for combining it with

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This may require amendments to the various Evidence Acts.

the information contained in Part One.

The purpose of the first part would be to answer the basic questions of:

(i) What kind of an investment fund is it?

(ii) What are its specific goals, objectives, volatility and risk profile?

(iii) How is it going to achieve what it wants to do?

(iv) Who is going to give it advice and provide it with management and administrative services?

(v) How will these people be paid and what will it cost for these services?

(vi) What conflicts of interest are there and how will my interests be protected?

Included with the information to be provided in connection with the foregoing would be a concise, but nevertheless precise, statement of the investment objective and strategies of the investment fund. If these change, this would be required to be disclosed. The first part would also contain an outline of the risk profile of the investment fund and indicate the type of investor that the investment fund is suitable for. It may be desirable to develop a standard format for certain aspects of the disclosure for the different types of funds. This should be considered in conjunction with the recommendations made in Section 24 relating to performance information.

Full details about the fees, charges and other expenses that will be charged to the investment fund and about those that will be charged directly to the investor would be required to be set forth. Examples of the effect of these fees, charges and expense on an investment of $1,000 at the end of a one year, three year, five year and ten year period, assuming a 5 per cent annual return and redemption at the end of each period, would be required to be given. If the investor is able to choose from a variety of sales charge options, examples would have to be given in respect of all of the available choices, with the maximum charge that may be made within each option being used for the purpose of the hypothetical example. All examples should be required to include the dollar amounts in addition to percentage amounts.

In addition, summary financial information would be included covering a period that is the lesser of ten years or the life of the investment fund. The type of summary information would include information about the net asset value per unit or share at the beginning of the period, income from investment operations, distributions from net investment income, capital gains and return of capital, and net asset value per unit or share at the end of the period. The information would also include the aggregate net assets at the end of the period, the ratio of net investment income to average net assets, the ratio of expenses to average net assets, with perhaps the significant items of expenses shown separately, and the portfolio turnover rate.

Consideration could be given to allowing total return information to be presented for the abovementioned period with an indication of quartile ranking and a comparison of the investment fund's performance with the risk profile. I recommend that this only be considered if the concerns about performance information that are outlined in Section 24 are addressed.

In addition, the first part of the point of sale disclosure document would contain a statement that the base disclosure document, the annual and interim reports and the material change reports are incorporated by reference into the point of sale disclosure document and that a copy of these documents will be furnished to investors on request. An appropriate certificate would be required to be signed that would in effect make these documents into a prospectus with statutory liability for misrepresentations.

Part Two of the point of sale disclosure document would be required to be completed by each distributor and would be required to contain full details in plain and simple language of all sales charges, transaction charges, account-opening fees, administrative charges, any other type of fees, charges or reimbursements, service fees and sales incentives of every nature and kind that the distributor and the sales representative will receive, directly or indirectly, from:

(i) the investor, and

(ii) any of the investment fund, its manager, its principal distributor, any portfolio manager of the investment fund or any of their respective affiliates or associates.

Examples would be required to be given illustrating the effect that the foregoing has on the investor's total return over a period of the lesser of ten years and the life of the fund using the same assumptions that are referred to in the example that is to be contained in Part One. When percentages are used, an example in actual dollar numbers should also be given.

If portfolio transactions for the investment fund are executed by the distributor or any associate or affiliate of the distributor, disclosure of this should be made with particulars given.

I expect that further work will have to be done with respect to working out the details for the foregoing and it may be that the examples in Parts One and Two will have to be consolidated in order to achieve the purpose of unequivocally telling the investor in plain and simple language what his or her investment is effectively costing.

The distributor should be required to sign an appropriate certificate about the information it has provided that will create statutory liability in the event of misrepresentation.

Withdrawal and Rescission Rights

Industry participants have questioned the appropriateness of the statutory rights of withdrawal and rescission applying to the sale of securities of investment funds.

The concerns relate to the fact that these rights in effect give investors an option. I am

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At page 280 of his book, *Bogle on Mutual Funds - New Perspectives for the Intelligent Investor,* John Bogle states:

> "If mutual fund investors become more cognizant of the costs they are paying in the form of sales loads, management fees, and other fund expenses, and then act on this awareness, these costs will surely decline. It is as simple as that. If you purchase only the shares of the lower-cost funds (perhaps even by redeeming your investments in the higher-cost funds), mutual fund sponsors will quickly get the message. They'll learn that reducing their costs to investors will help them to increase the level of assets that they manage; failing to do so will lead to an unremitting capital outflow."

advised that if investors want out and the value of the securities has increased, they simply redeem and keep the profit. If the value of the securities has decreased, the investors exercise the withdrawal rights with the result that the dealer who sold them the securities bears the loss. This is obviously not what was intended to happen when withdrawal rights were provided for in securities legislation.

Recommendation

It is my recommendation that in the case of an investment fund, the statutory right of withdrawal be modified to provide that the amount payable to an investor who exercises the statutory right of withdrawal be limited to the lesser of: (i) the amount invested in the investment fund, and (ii) the net asset value of the securities next determined following receipt of the notice exercising the right of withdrawal plus the amount of any sales charge that has been paid. No deduction should be permitted to be made for any deferred sales charge.

The question of whether the proposed short-term trading fee should be deducted from the amount payable to an investor who exercises a statutory right of withdrawal is a difficult one. If such fee is not required to be deducted, it is not unreasonable to expect that the purpose for which the fee is provided will be circumvented. Perhaps a solution to the problem would be to provide that the short-term trading fee will not be deducted where the purchase in question is less than $25,000.

In the case of an investor who alleges that he or she was misled by a misrepresentation contained in the prospectus documents, such investor should be able to exercise the statutory right of rescission. However, this right should be modified to provide that the amount payable to investors who exercise this statutory right of rescission is limited as outlined in the preceding paragraph.

I was told that there are some other problems with how the statutory rights of withdrawal and rescission work. However, particulars were not provided and as I was left with the impression that these problems were not unique to investment funds, I have not pursued this matter for the purposes of this report. I suggest that the follow-on work arising out of this report review in more depth than I have been able to, the subject of withdrawal and rescission rights and, if there is further action that needs to be taken with respect to this matter, that it be taken.

Reference is made to the proposal in Section 27.03 for the reinstatement of a short-term trading fee which is to be payable to the investment fund in the event that an investor redeems the securities that the investor has purchased within 90 days of purchase.

18. ESTABLISHMENT AND GOVERNANCE OF INVESTMENT FUNDS

The third broad area in respect of which I recommend that regulatory action be taken relates to the establishment and governance of investment funds. My recommendations with respect to these matters are set out in this Section 18 and should be read together with the recommendations set out in Section 14 relating to the management of investment funds and to the recommendations set out in Sections 19, 20 and 21 relating to conflicts of interest and other related matters.

As noted in Section 14, it should be kept in mind that the general practice in connection with the establishment of investment funds is for an investment fund organization to cause an investment fund to be established on the basis that the investment fund organization will be responsible for providing or causing to be provided to the investment fund all of the services required by the investment fund to carry on its operations in the ordinary course.

18.01 Structure of Investment Funds

Most investment funds (i.e. most open-end investment funds) are structured as trusts rather than as corporations because of the fact that the flow-through treatment for income and capital gains that is provided under tax law to unit trusts is not available to corporations. As discussed in the Canadian Committee Report, there are minimal legal restrictions governing the content of trust instruments which create the investment funds. This leaves investment fund organizers with a lot of flexibility in the decisions they make as to what the relevant provisions of the trust instruments will be. In contrast, investment funds that are structured as corporations are subject not only to the extensive statutory provisions embodied in the corporate legislation of the jurisdiction of incorporation but to

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Although there are refunding formulas that apply with respect to dividends received by a mutual fund corporation from Canadian corporations and with respect to capital gains realized by a mutual fund corporation, a mutual fund corporation does not provide a full conduit to shareholders in respect of interest income and foreign income received by it and is considered to be "tax inefficient" by reason of the fact that tax is payable at the corporate level as well as in the hands of its shareholders.

Supra, note 20 at page 25.

the extensive body of law applicable to corporations. As pointed out in the Canadian Committee Report, the average investor is unaware of the difference between the laws that regulate trusts and those that regulate corporations.

Recommendations

I think that the differences in investors' rights flowing from whether an investment fund is structured as a corporation or as a trust should be eliminated and the negative tax aspects of mutual fund corporations should be removed. My recommendations in this respect are to:

(1) seek to have the tax laws changed so that full flow-through treatment would be available to investment funds that are structured as corporations; this change would serve to eliminate the bias for tax reasons to structure the investment fund as a trust; and

(2) seek to have legislation enacted that would give statutory recognition to a business trust structure that is akin to a corporate structure and would include provisions for "directors" and "officers" of the trust, the extent of their independence, how they are to be elected and removed, how fundamental changes in the trust are to be effected, unitholders' rights and remedies and other relevant provisions comparable to those that are found in corporate statutes.

18.02 Statutory Basis for the Regulation of Mutual Funds

The Canadian Committee Report recommended that legislation be enacted specifically to govern the operations of mutual funds and that such legislation be flexible enough to take into account the regulatory environment within which the industry now operates and to allow for innovation. Following the release of the Canadian Committee Report, some of its recommendations were reflected in amendments to provincial securities legislation. However, many of its recommendations were implemented by the CSA through policy statements issued to outline how the CSA proposed to exercise its discretionary authority. The various CSA policy statements in this respect have been consolidated and are

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There is well-developed legislative precedent for "business trusts" in the United States.

restated as National Policy Nos. 39 and 36.

In view of the Ainsley and the Haldenby decisions, which raise questions about the authority of securities regulatory authorities to adopt policy statements that are in effect mandatory in nature and raise questions about the authority of the Lieutenant Governors in Council to make regulations in the absence of express statutory authority authorizing the same, it is desirable to remove any doubt as to the foundation of the principles that are applicable to investment funds that are reflected in National Policy Nos. 39 and 36.
The Securities Amendment Act, 1994 (which reflects the legislative initiatives to implement the recommendations of the Ontario Task Force on Securities Legislation) provides for the recognition on a transitional basis of National Policy Nos. 39 and 36 as rules.

Recommendations

Fundamental Principles to be Reflected in Legislation

While the provisions of the Securities Amendment Act, 1994 deals with the matter in the short term, I think that the fundamental principles respecting investment funds should be reflected in legislation as opposed to regulations, rules or policies. This will necessitate

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Ainsley Financial Corporation et al v. Ontario Securities Commission (General Division) (1993), 14 O.R. (3d) 280; (Court of Appeal) [1994] O.J. 2966; (1995) 18 OSCB 43.

Her Majesty the Queen and Donald Haldenby, Ruling dated August 29, 1994 by Fairgrieve Prov.J., Provincial Offences Court, Toronto Region, Ontario Court of Justice (Provincial Division)

The *Securities Amendment Act, 1994*, S.O. 1994, c.33 was proclaimed in force on January 1, 1995 with the exception of Section 143.1 which was proclaimed in force on March 1, 1995. The main purpose of this Act is to authorize the Ontario Securities Commission to make rules of a legislative nature that will be treated as subordinate legislation in the same manner as the regulations on the same subject matter made by the Lieutenant Governor in Council. Section 143.1 "grandfathers" for a two year period all blanket orders and rulings as well as specified policies. The delay in the coming into force of this Section is to provide time to amend the Regulation under the *Securities Act*, R.S.O. 1990 c. S.5 (as amended) to delete conflicts between the Regulation and the blanket orders, blanket rulings and policies. In the meantime, these blanket orders, blanket rulings and policies will continue in effect notwithstanding the amendments to the *Securities Act.*

Responsibility and Responsiveness: Final Report of the Ontario Task Force on Securities Regulation, June 1994, Queen's Printer for Ontario

My reasons for this view are based upon my belief that fundamental principles of law should be set forth in a review of the present policy statements to determine which of the existing provisions should be reflected in legislation as opposed to regulations, rules or policies as well as a review of what fundamental principles are not reflected in the present policy statements that should be reflected in legislation. I recommend that this review be part of the follow-on work resulting from this report. As well, many of the recommendations contained in this report will, if implemented, require legislative action.

Legislative Regime for Investment Funds

In discussing with industry participants the question of whether it would be desirable for there to be a separate legislative regime for investment funds which would deal with the fundamental principles respecting investment funds, people were almost evenly divided on the question of whether there was a need for a separate investment funds statute or whether the appropriate provisions could be provided for by adding separate sections to existing statutes, with there being a slight preference in favour of adding separate sections to existing statutes. A related question is whether the appropriate legislative action should be effected by having each Canadian jurisdiction enact identical laws or by having federal legislation enacted.

I think that the decision as to whether there should be a separate statute or separate sections added to existing statutes must await the determination of what needs to be reflected in statutory provisions.

With respect to the question of whether the appropriate legislative action should be effected by having each Canadian jurisdiction enact identical laws or by having federal laws enacted, I think that the decision in respect of this matter must also await the determination of what needs to be reflected in statutory provisions and the determination of what the ultimate structure of the regulatory system for regulating investment funds will be.

In any event, regardless of whether there is a separate statute or separate sections in

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legislation enacted by the legislature. Regulations, rules and policies should be confined to implementing these fundamental principles.

See Section 4**.**

existing statutes and regardless of whether the legislation is enacted by each Canadian jurisdiction or federally, there must, in my opinion, be no doubt about the legislative authority to regulate investment funds.

18.03 Discontinued Offerings by Investment Funds

One problem with the current regulatory regime is that many of the requirements that are applicable to investment funds apply only so long as the investment fund is being offered for sale in a jurisdiction.

Recommendation

There is a need for legislative action to provide that the fundamental requirements that are applicable to investment funds continue to apply to investment funds notwithstanding that their securities are no longer being offered for sale in a jurisdiction.

18.04 Investment Fund Governance

As noted above, investment funds are created by investment fund organizations on the basis that the investment fund organization will be responsible for providing or causing to be provided to the investment fund all of the services required by the investment fund to carry on its operations in the ordinary course. In many cases, the investment fund organization causes the investment fund to be created pursuant to a trust instrument that provides for it (or its affiliates) to be the trustee and manager. In other cases, the investment fund is established as a corporation, with the investment fund organization providing the requisite services pursuant to contractual arrangements.

In neither case are there requirements that "outside directors" or "unrelated persons" be involved - i.e. persons who are free of relationships and other interests which could, or could reasonably be perceived to, materially interfere with the exercise of judgment in the best interests of the investment fund.

As observed in Section 14, I believe that there is something inherently wrong with a structure that permits all of the functions that are required to be carried out in respect of an investment fund to be carried out by related parties on terms that are in effect unilaterally imposed without there being some degree of review by unrelated persons who are considering the merits solely from the perspective of the best interests of the investment fund and its investors.

In the current structure, there is no one whose sole responsibility it is to look out for the interests of investors and it is not clear that the primary obligation of the investment fund manager is to put the interests of its sponsored investment funds ahead of all other interests. As noted in Sections 2 and 3, investment fund organizations are focussed on gaining market share and benefitting their shareholders and other stakeholders. Their focus is not exclusively on their obligations to their sponsored investment funds.

Most countries require that "independence" be built into the structure and governance of investment funds either through the mechanism of requiring an independent trustee and custodian (i.e. a trustee and custodian that is not related in any way to the investment fund organization) which will be responsible for carrying out functions that cannot be delegated, or by having a specified percentage of outside directors of the investment fund.

There were divergent views expressed about the merits of extending by analogy the statutory requirement for a board of directors that exists in the case of an investment fund that is a corporation to an investment fund that is a trust or other entity and to requiring that in either case there be a specified majority of "outside directors" on such boards, with most people being opposed to the idea. The reasons given for this opposition include: (i) the multiplicity of investment funds within each group of sponsored investment funds, (ii) the increase in investment fund costs, (iii) the increase in time, paperwork and procedural workload required by investment fund managers to provide the board of the investment fund with information, (iv) proficiency issues respecting the persons selected to serve on the boards, and (v) the shortage of suitable people.

It is important to keep in mind the distinction between requirements that there be "outside directors" on the board of directors of the manager of the investment fund and requirements that there be "outside directors" on the board of the investment fund. The discussion and recommendations with respect to the requirements that there be "outside directors" on the board of directors of the manager of the investment fund are set forth in Section 14 of this report. The discussion and recommendations with respect to there being "outside directors" on the board of the investment fund are set forth in this Section 18.

In questioning the need to require independent boards at the investment fund level, people referred to the fact that investment fund managers are currently under a specific statutory duty with respect to the investment funds they manage. They suggested that rather than adding another layer of supervision with the same supervisory duties it is preferable to increase the periodic management certification and audit procedure requirements to address specifically areas of potential conflicts and fair treatment of investors with respect to such matters as: (i) allocation of fund expenses, (ii) adequacy of fund valuation procedures, (iii) maintenance of capital levels, (iv) compliance with investment objectives, (v) adequacy of transfer agency services, and (vi) compliance with procedural requirements.

It was pointed out that investment fund managers that are public companies currently have boards of directors that have some "outside directors" and are required to have audit committees, a majority of the members of which are "outside directors". In some cases, these audit committees unofficially act as audit committees of the investment funds and in this context review expense allocations and the annual audited financial statements of the investment funds, meet with the external auditors of the investment funds and with internal accounting staff and review with the auditors the adequacy of all accounting controls as they impact the investment funds. It was observed that these boards and audit committees are aware of the statutory obligations of the investment fund manager and that they challenge management regularly as to the adequacy of procedures, controls, prospectus disclosure and other matters. It is suggested that rather than add a second board at the investment fund level, it would be better to prepare a list of matters that would have to be certified by management, the board of directors and the audit committee of the investment fund organization.

The suggestion was made that there should be a difference between the requirements for investment fund organizations that are public entities and investment fund organizations that are private entities with respect to any requirement that may be imposed to have "outside directors". It has been pointed out that in the United States where there is a requirement to have "outside directors", very few of the investment fund managers are public entities. Accordingly, it has been suggested by some that if investment funds are managed by an investment fund organization that is not a public entity there should be a requirement that such investment funds have a board comprised of a majority of "outside directors".

It was suggested that if investment funds are to be required to have independent boards, there should only be a requirement for there to be a single board for all funds within the group(s) of funds sponsored by the investment fund organization. I am told that the reason for this suggestion that there be a single board relates to the difficulties that it is perceived that there would be in building the knowledge and awareness levels of the directors with respect to investment fund matters, preparing information for them and meeting with them and that it would be unduly onerous, in view of the number of investment funds, to have to do this with different boards for each investment fund managed by the investment fund organization or even with different boards for each group of investment funds managed by the investment fund organization.

It was pointed out that if independent boards of investment funds are to be required, there is a need to specify clearly the duties and responsibilities of any such boards and it has been suggested that these duties and responsibilities should be concentrated on conflicts, fairness and procedural issues. It was emphasized that the role of the independent board should not be to second-guess the investment decisions of the portfolio manger, or the decision to offer new funds, or to make changes in investment objectives of a fund, or to approve prospectuses, or to determine whether the manager has performed its statutory duty. It was suggested that the board should report its findings regularly to the manager and that it should provide a mechanism to correct any perceived shortcomings within a fixed period of time. If the board is not satisfied with the actions taken by the manager, the board should report to securityholders and to the appropriate securities regulatory authority so that further action could be taken.

With respect to the submission referred to above that enhanced review and reporting procedures for the board of directors of the investment fund manager, its audit committee and the external auditors of the investment fund manager would provide the same assurances that independent boards of investment funds would provide and at much less cost, I do not agree with the underlying thought reflected by this submission. In my opinion, enhanced requirements with respect to investment fund managers are desirable in their own right and should not be viewed as an alternative to an investment fund having

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See Section 14.

an independent board.

Questions have been raised about whether, if investment funds have boards, this will require annual meetings for all investment funds to be held, the provision of management information circulars and proxy voting. It has been pointed out that the costs of these requirements will ultimately be borne by investment fund investors. Questions have been asked as to whether the fund manager or the board would be responsible for conducting the process, who would be willing to serve on the boards, how would the "outside directors" be selected, what would the appropriate indemnification and insurance levels be and would the investment funds or the investment fund organization bear the cost of the directors/trustees' fees and insurance costs for the "outside directors". These are legitimate administrative questions to raise but they do not go to the substantive issue of whether there is a need for independent boards.

I think that the questions raised by those who do not consider that there is a need for an investment fund to have an independent board overstate the problems presented by the possibility of there being a requirement for an independent board and the costs that would be involved if this were to be required. I am told that the information required to keep the members of an independent board of the investment fund informed is basically the same information that a manager requires. With respect to the question of whether there is a sufficient number of skilled people available to serve as independent members of the boards of investment funds, the basic need is for sound business persons who understand their responsibilities as directors. In my opinion, there is an obligation on the part of the investment fund manager to advise the outside directors on its own board and of the boards of its sponsored investment funds of what the issues are so that informed decisions can be made and actions taken. The costs involved should more than be offset over the long run as it is reasonable to expect that the enhanced review and scrutiny of proposed transactions should result in more efficiently-run operations, lower fees being charged to investment funds and more controls exercised over the expenses that are charged to investment funds, particularly in cases involving transactions between the investment fund manager (or parties related to the investment fund manager) and its sponsored investment funds.

Recommendations

Accordingly, in addition to the recommendations that I have made in Section 14 regarding the board of directors of an investment fund manager, its audit committee and the enhanced procedural and reporting requirements in respect of the operations of the investment fund manager, it is my recommendation that:

(1) Investment funds should be required to have an independent board. The fact that tax laws have encouraged the use of structures other than corporations to constitute investment funds should not, in my opinion, eliminate the basic governance mechanisms reflected in a corporate structure. The recommendations in Section 18.01 are intended to eliminate this difference.

I note that corporations that offer their securities to the public are required by law to have "outside directors". I do not see any reason why an investment fund the securities of which are offered to the public should be any different.

While my recommendation that investment funds have independent boards goes beyond the current requirements of corporate law and the corporate governance guidelines recommended in the Dey Report that merely encourage the board of directors of a public company to be comprised of persons, a majority of whom are unrelated persons, I believe that there is justification for this by reason of the unique relationship that exists between the investment fund and its manager. This relationship gives rise to conflict of interest situations that occur on a continuing basis in the ordinary course of business and otherwise. In view of the fact that it is impractical for each situation involving a conflict of interest to be referred to securityholders for approval, it is essential that there be an independent body

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The term "independent board" is used in this report to refer in the case of an investment fund that is constituted as a corporation, to its board of directors and, in the case of an investment fund that is not constituted as a corporation, to a board of governors or an advisory committee or other entity with equivalent duties and responsibilities to those of a board of directors of a corporation, which board, in either case, is comprised of persons, a majority of whom are "unrelated persons". The term "unrelated persons" is used in this definition of "independent board" to mean persons who are free of relationships and other interests which could or could reasonably be perceived to materially interfere with the exercise of judgment in the best interests of the investment fund.

Supra, note 51.

whose sole focus is the interests of the investment fund and its securityholders. It is also essential in the current environment affecting the investment fund industry where investment fund organizations are under considerable pressures to build critical mass and to secure access to distribution channels in order to survive, that there be such a body.

(2) The applicable principles of good corporate governance (e.g. audit committees that are composed of at least a majority of unrelated directors) that are outlined in the Dey Report or will be articulated as a result of the follow-on work referred to below should guide the investment fund organization in establishing an independent board.

(3) To the extent that an investment fund organization deviates from the principles of good corporate governance that are outlined in the Dey Report or as a result of the follow-on work referred to below, it should include in the base disclosure document for the investment fund and in the annual report of the investment fund the reasons for any deviation from these guidelines.

(4) Further work should be done to identify the specific principles of good investment fund governance that should be applicable to investment funds so that there is uniformity of approach to this matter and investors are advised of what the standards are and are able to assess whether the protections offered by the respective investment fund organizations are sufficient. It may be that some legislative action is needed in this regard but this determination needs to await the articulation of what the appropriate principles of good investment fund governance should be.

As a minimum, there should be a requirement that mechanisms be in place to ensure that someone is reviewing all actions to ensure that they are in the best interests of the investment fund and its investors. This does not mean, nor should it result in, second-guessing the legitimate investment decisions of the portfolio manager. However, it does mean, for example, that there should be an audit

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See Sections 2 and 3.

committee with clear responsibilities in respect of the investment funds, including the review of expense allocations and the annual financial statements of investment funds.

I would expect that a result of the follow-on work would include guidelines aimed at: (i) clearly specifying the duties and responsibilities of an independent board that are focussed on conflicts, fairness and procedural issues, (ii) the development of effective procedures to address and remedy any unresolved shortcomings that may be identified by the independent board, and (iii) the development of appropriate provisions to address the administrative questions outlined above, many of which will be required to be dealt with in the development of the constating legislation referred to in Section 18.02 that I have recommended be passed. There is also a need to address the procedure for nominating persons to serve on the independent board and for filling vacancies that occur. In addition, there is a need to address the criteria for determining whether nominees are "free of relationships and other interests that could or could reasonably be perceived to materially interfere with the exercise of judgment in the best interests of the investment fund". In this respect, there is a need to address the issue of how many "independent boards" an individual can be on before questions arise about whether the individual is "free of relationships and other interests that could or could reasonably be perceived to materially interfere with the exercise of judgement in the best interests of the investment fund".

18.05 Changes to Requirements for Investment Funds

During the course of my review, people have talked with me about the desirability of making changes in the current requirements for investment funds that are set out in National Policy No. 39. My recommendations in this respect are outlined in Section 27.

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19. CONFLICTS OF INTEREST

Examples of such procedures could include notifying securityholders and regulators of the concerns, obtaining securityholder approvals, with the independent board having the right and the obligation to outline its concerns in the information circular furnished in connection with the meeting of securityholders, and the appointment of an interim manager depending upon the nature of the concerns.

The single most difficult issue of all of the issues that have been raised in the context of investment funds is how to deal with situations involving conflicts of interest.

Situations which involve potential conflicts of interest arise in connection with every investment decision or other transaction where there is a reason to question whether the investment decision or other transaction was motivated by considerations other than what is in the best interests of the investment fund and its securityholders.

This is not a new issue. The Canadian Committee Report in discussing the subject of potential conflicts of interest, observed that:

> "Control of potential abuses arising from conflicts of interest is a perennial topic of discussion because of its intrinsic importance and because it presents a host of difficult value judgments each of which requires that the scope of what is desirable be weighed against an assessment of what is workable in practice".

These words were true in 1969 and they are still true today.

19.01 Current Regulatory Model

Today's regulatory model is based on the recommendations contained in the Canadian Committee Report which reflected its best judgment of: (i) what issues needed to be addressed with respect to situations involving potential conflicts of interest, and (ii) how to balance what is desirable against what is workable in practice. Today's approach is based on:

- identifying and prohibiting certain transactions involving related parties and self-dealing that could be potentially abusive of the interests of the investment fund;

- providing the securities regulator with the ability to grant exemptive relief either in

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Section 9.02 of the Canadian Committee Report.

respect of a particular transaction or a class of transactions;

- prohibiting investments to be made by an investment fund which will result in a related party receiving payment of undisclosed fees or other compensation, with a provision allowing exemptive relief to be granted by the securities regulator;

- imposing a fiduciary standard of care on everyone who is responsible for the management of the investment fund;

- requiring reporting of various related party transactions, with a provision allowing exemptive relief to be granted by the securities regulator;

- prohibiting persons with access to information concerning the investment program of an investment fund from buying or selling securities of an issuer for such person's own account where the portfolio securities of the investment fund include securities of that issuer and the information is used by the person for such person's direct benefit or advantage;

- making contravention of these statutory provisions an offence; and

- providing for a derivative type of civil action to be instituted by the investment fund or the securities regulator.

In arriving at its recommendations, the Canadian Committee was influenced by the approach taken in the United States, which is reflected in the provisions of the Investment Company Act of 1940, as well as by the proposals contained in the bill that was being proposed for passage in Ontario as the Business Corporations Act, 1968 and in the series of bills that were being proposed for passage federally to amend the Investment Companies Act, the Canadian and British Insurance Companies Act, the Loan Companies Act and the Trust Companies Act.

Until 1987, this approach seemed to work relatively well and there was general acceptance of it.

19.02 Deregulation of the Financial Services Industry

With the deregulation of the financial services industry that occurred in 1987 (which is sometimes referred to as the "collapse of the four pillars") and the removal of both the restrictions on the ownership of and on what businesses the four pillars (banks, trust companies, insurance companies and investment dealers) could carry on, the traditional division of business functions among the different pillars disappeared.
Most of the major investment dealers are now owned by banks. Banks are now permitted to establish and manage their own proprietary investment funds and to provide discretionary investment management services to individuals, pension funds and other institutional investors. Banks have been permitted to acquire trust companies which are also permitted to establish and manage their own proprietary investment funds as well as to maintain common trust funds to service their estate, agency and trust accounts and to provide discretionary investment management services to individuals, pension funds and other institutional investors. Insurance companies have acquired, or have entered into alliances with, investment fund managers and other portfolio managers. Some trust companies and insurance companies are controlled by commercial interests.

At the same time, the investment fund industry generally has been affected by the shift from transaction-based services to relationship-based services, demographic forces, intense competition and technological changes. With new entrants to the investment fund industry, new instruments being developed and new methods being devised for advising and selling investment funds, new situations involving potential conflicts of interest have arisen. For example, the effects of financial institutions moving their loans off their books by securitizing such loans is likely to have major implications for all investment funds but particularly for those who do not deal at arm's length with the financial institution.

In a speech made to the Western Business Symposium at the University of Western Ontario on April 8, 1994, Mr.A.L.Flood, Chairman and Chief Executive Officer of the Canadian Imperial Bank of Commerce defined "securitization" as the conversion of loans into more liquid and marketable assets. In discussing securitization, he observed that:

> "Securitization is bound to spread. I can see it overlapping the mutual funds area so that institutions will be able to securitize clusters of loans and sell them to funds. This could also happen with residential mortgages or credit card receivables. It is happening faster than any of us imagined".

He went on to refer to the fact that in 1988, Lowell Bryan, a director of McKinsey & Co. and an expert in

What has changed from 1969 and from 1987 is that today the ability of a related party to execute portfolio transactions for the investment fund and to supply investment product to the investment fund is virtually unlimited. This adds a whole new practical dimension to the scope of transactions that are within the regulatory proscriptions. Accordingly, it is not surprising that financial conglomerates (as well as others) want to be relieved from the prohibitions that prevent:

(i) the execution of portfolio transactions on a principal basis through a related party;

(ii) the purchase of securities of or guaranteed by, or offered by, a related party; and

(iii) related parties from buying and selling securities directly to and from each other.

Financial conglomerates have argued that the current regulatory regime is no longer appropriate and that, as a minimum, exemptive relief should be granted to permit the above transactions. They argue that investors in their proprietary funds are adversely affected by these prohibitions and that therefore the prohibitions ought to be removed or at least varied to permit prohibited transactions within certain parameters.

They argue that the fiduciary standard of care that they are obliged to maintain should be a sufficient safeguard of investors' interests from the regulatory point of view.

19.03 Questions for Regulators to Address

I suggest that the questions that securities regulators need to address in considering whether changes should be made to the regulatory requirements with respect to related party transactions include the following:

! Are the current restrictions adversely affecting the interests of the investors that

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financial services, estimated that it would take 10 to 15 years before securitization replaces traditional lending. Mr. Flood noted that we are now in year five and securitization is close to supplanting lending in the United States and that it can be expected that Canada will catch up quickly.

they are designed to protect?

! If the answer to this is "yes", would removing the current restrictions adversely affect the interests of the investors that they are designed to protect?

! If the answer to the second question is "yes", should the current restrictions:

(i) be changed and, if so, how should they be changed, or

(ii) remain unchanged,

! with no exemptive relief being granted; or

! with exemptive relief being granted if the Securities Regulator is satisfied that the interests of the investors will not be adversely affected?

! What evidence should the Securities Regulator have in order to make any of the above determinations or, to be satisfied, in the case of granting exemptive relief, that the interests of the investors will not be adversely affected?

! If the present restrictions are relaxed:

! What potential risk could this pose for the investment fund manager or its affiliates in the event of an assertion by or on behalf of the investment fund that the investment fund manager or its affiliates breached their respective fiduciary obligations?

! Could such potential risk adversely impact on the solvency of the investment fund manager or its affiliates?

! Could such potential risk adversely impact on the reputation for integrity and the resultant trust that the investment fund industry has enjoyed?

! Could this potential risk adversely impact on the credibility of the Canadian capital markets?

! If the answers to any of these questions are in the affirmative, should the requested relief be subject to the approval of any of the other regulators having jurisdiction over the investment fund manager or an affiliate of the investment fund manager?

19.04 Technical Problems

Staff of the OSC has identified a number of questions about how the current statutory provisions should be interpreted and has raised questions as to the scope of the provisions in light of certain defined terms and the anomalous consequences depending on how an organization is structured and whether an organization is a member of a self-regulatory organization. OSC staff has also identified questions about the interpretation and application of the provisions contained in National Policy No. 39 respecting restrictions on related party and self-dealing transactions. Staff's analysis is contained in a paper which I understand will be published following the release of this report.

19.05 Guiding Principles

I am not going to attempt to answer the questions that I have posed in Section 19.03 nor am I going to attempt to deal with the anomalies contained in the current regulatory provisions. Rather, what I propose to do is to recommend some guiding principles to be taken into account in determining what approach should be taken to these matters.

In talking with industry participants, several people suggested that the present regulatory regime may suffer from the inarticulation of sufficient underlying principles. It was suggested that we need fundamental regulatory principles that would in effect serve as a guiding light that could be applied to all fact situations. The observation was made that the problems with the current regulatory regime relate to the fact that there are gaps in its application and that we need a "seamless" system.

It was suggested that the fundamental underlying regulatory principles should focus on aligning all "non-customers" on one side and all "customers" on the other side and providing that "customers' interests always come first". While I agree with the merits of the suggestion, it covers only one element of what I think needs to be reflected in fundamental underlying regulatory principles that are designed to address the complexity of the relationships that exist today.

I suggest that the fundamental underlying regulatory principles need to be based on the obligations of fiduciaries:

(1) not to place themselves in a position where their own interests conflict with those of their customers - i.e. the beneficiaries - (the "no conflict" rules);

(2) not to profit from their positions at the expense of their customers (the "no profit" rules);

(3) of undivided loyalty to their customers which means that they may not place themselves in a position where the fiduciary's duty to one customer is in conflict with the fiduciary's duty to another customer (the "undivided loyalty" rule);

(4) to use information obtained in confidence from one customer only for the benefit of that customer (the "duty of confidentiality").

Although these duties are not expressly articulated in the current regulatory regime, I think that they do form the basis for the approach that has been taken and it might be desirable that this be reflected in any statutory amendments that may be made or rules or policies that may be adopted.

The suggestion was made that if there were to be a set of articulated fundamental underlying regulatory principles, the specific prohibitions against certain transactions might be eliminated in favour of a series of transactions that are "reviewable practices". From the perspective of investor protection, I fail to see the sufficiency of this suggestion to address the issues that are raised by the requests for exemptive relief referred to below.

19.06 Endorsement of the Current Regulatory Approach

I think that the current regulatory regime, which made sense in 1969, makes even more sense today.

The very type of transactions that some industry participants are suggesting should be exempted from the statutory provisions that prohibit them are the same type of transactions that the Canadian Committee Report identified as transactions or practices that could be potentially abusive of the interests of investors. Financial deregulation has not obviated the merits of a regulatory approach that prohibits these transactions; it has, in my opinion, reinforced the need for such an approach.

I therefore do not recommend changing the current regime beyond amending the various securities statutes to provide for uniform application of the provisions, clarifying any interpretative problems or technical deficiencies, and including (or expanding upon) a fundamental regulatory principle that articulates the fiduciary obligations discussed above.

The current regulatory regime contemplates that exemptive relief may be granted in appropriate circumstances. My recommendations with respect to the granting of exemptive relief are set out in Section 19.10.

19.07 Uniform Application to All Managed Accounts

I recommend that the provisions regulating conflicts of interest and self-dealing should apply to all managed accounts regardless of whether they are mutual funds, individual accounts, pension funds, pooled accounts or other types of accounts and regardless of whether the portfolio manager is or is not a member of a self regulatory organization. In this respect, I do not think that it is appropriate for a self-regulatory organization to have the power to exempt portfolio managers from the provisions regulating conflicts of interest and self-dealing.

19.08 Structural and Functional Separation

Arguments have been made that if there is structural and functional separation between the portfolio manager and the related parties, this should create a sufficient degree of independence to permit the portfolio manager to engage in transactions with related parties that would otherwise be prohibited. It is argued that the fact of ownership and control becomes irrelevant if you have structural and functional separation.

I do not agree with this argument. As long as a related party is able to exercise control or direction over the portfolio manager (whether by way of ownership or otherwise), I do not think that structural and functional separation creates the degree of independence that warrants removal of the prohibitions on related party and self-dealing transactions.

This view is shared by some of the industry participants with whom I talked. These industry participants, in expressing their concerns about allowing related parties to enter into transactions with managed accounts that are currently prohibited, emphasized that notwithstanding how firms are structured and how organizational functions are separated, there will always be pressure to place new issues that a related dealer is having difficulty in selling into managed accounts.
They observed that regardless of the structural and functional separation of activities, if the management climate and/or structure of an organization should change, the personal integrity of people can be subjected to a lot of pressure. The observation was made that people have problems separating their integrity as an individual from the bigger pressures that may be brought to bear on them organizationally and that although people may think that they would be prepared to resign if this pressure were brought to bear, the question is whether they would in a tough economic environment. The comment was made that few people would have the integrity to go; those without integrity would stay and the abuses would occur.

It was also noted that there is not always the propensity throughout an organization to do everything right. A lot of pressure is brought to bear by managerial attitudes that are reflected in phrases such as: "everybody else is doing it" or "no-one else is doing it". Sometimes there are people in authority and power who misuse their authority and power or who are lacking in ethics or experience or both. It was also noted that not everything is "black or white" and that it is easy to slip into "grey areas" and to keep on slipping until without noticing it, the line has been crossed into "black".

It was observed that venerable organizations change. Financial institutions hold themselves out as being what they once were but financial institutions change, both in relation to the businesses that they conduct and in relation to the senior management responsible for how business is conducted. The observation was made that new management often has different perspectives and that we have seen the effects of these different perspectives at the financial institutions that have failed. In making these comments, reference was made to how people at these institutions who thought their integrity was unimpeachable allowed things to happen that they would not ordinarily have allowed.

The observation was made that the pressure comes from those who pay your salary, determine your bonus and determine whether you are promoted. The pressures are subtle - "I believe this is good" - "I am not asking you ... " - "We have dealt with them for years ... " - "We only underwrite quality issues ... " - "This won't affect your yield ..." and so on. The comment was made that the moment that dealers sense that an issue is not going well, they will sell it into the managed accounts but there will never be a bright line (or light) to show that this has been done.
With respect to the argument that investors who invest in an investment fund that is managed by an investment fund manager that is an affiliate of an investment dealer, are adversely affected by the investment fund not being able to participate in dealer-affiliate underwritings, it was observed that anyone can make money in a "bull" market and that hidden in the aggregate returns will be losses. It was observed that the "cost" of foregoing the opportunity for abuse is not too great a cost to pay, particularly in a "bear" market. It was also observed that having managed funds as "captive purchasers" will give the dealer/underwriter a great advantage in being able to underwrite in a "bear" market because it has control over where the securities will be placed.

The observation was made that disclosure that self-dealing is allowed will not add anything that will make what is basically an unacceptable practice, acceptable.

I agree with these observations.

19.09 Ratings, Liquidity and Limitations

Submissions have been made that if currently prohibited related party transactions were permitted to be entered into subject to requirements that the transactions involve securities that:

(1) have received an "investment grade" rating from a recognized rating agency;

(2) are liquid securities - i.e. are securities where there is a significant public float and that are readily marketable in a recognized public market; and

(3) are limited to specified maximum percentages:

(i) of the net assets of the fund that can be invested in such securities;

(ii) of the class of securities in question; and

(iii) of the number and value of the portfolio transactions;

these requirement should create sufficient safeguards to protect investors from any potential abuses.
In asking people whether they agreed with these submissions and whether they thought that statutory changes should be sought or exemptive relief granted to allow currently prohibited related party transactions to occur on this basis, the views that were expressed ranged from complete support to grave scepticism about the efficacy of the proposed conditions to safeguard the interests of investors.

Those questioning the appropriateness of such an approach did not think that either a "rating" or "market liquidity" added much investor protection. They observed that these factors are not proxies for independence and that although having investment grade, marketable securities in an investment portfolio was "good for investors", qualitative factors did not address the potential conflicts of interest issues surrounding how or when the securities came to be acquired or disposed of by the investment fund.

With respect to proposals to limit the maximum proportion of related party investments (as outlined in clause (3) above) that could be acquired for a managed account, those who questioned the appropriateness of making acceptable, transactions that potentially favour the interests of the portfolio manager or a related party over the interests of the investors in the managed account by putting some limitations around the quality and quantity of them, did not think that limitations on quantity, either alone or in combination with qualitative restrictions, addressed the fundamental concerns about the nature of the transactions in the first place. They observed that what the quantitative restrictions amounted to was establishing that potentially harmful transactions were acceptable and it was just a matter of negotiating how much would be considered to be too much.

They also did not think that disclosure that transactions of this nature were allowed would add anything that would make acceptable what were basically unacceptable practices. These commentators stressed the importance of maintaining the ***perception*** of fair dealing as well as the importance of maintaining the ***reality*** of fair dealing.

Recommendation

I share the concerns expressed by those who questioned whether placing qualitative and quantitative restrictions on currently prohibited related party transactions would justify removing such transactions from the category of prohibited related party transactions. Accordingly, I do not recommend that the CSA adopt such an approach.

19.10 Exemptive Relief

The current regulatory regime contemplates that exemptive relief may be granted in appropriate circumstances. I think that it is important for the Securities Regulator to retain the ability to grant exemptive relief in appropriate circumstances. However, subject to the recommendations contained in Section 19.11, I think that the power of the Securities Regulator to grant exemptive relief, if exercised at all, should be used sparingly, on a case-by-case basis, and upon the Securities Regulator being satisfied that the interests of the managed account and of the accountholders are adequately protected and do not favour the related party.

In the case of an investment fund, I recommend that exemptive relief should not be granted unless the investment fund has an independent board whose obligation it is to represent the interests of the investment fund and its investors and to see that the transactions

See Section 18.04.

involving related parties are in the best interests of the investment fund and its investors.

19.11 Exemptive Relief - Principal Transactions

Subject to the following comments, I do not recommend that any exemptive relief be granted from the current provisions that in effect provide that a portfolio manager of an investment fund may not cause the investment fund to engage in portfolio transactions on a principal basis with a related party.

***Bond Transparency* -** If and when the efforts to achieve "bond transparency" crystallize in a manner that makes the information regarding "spreads" publicly available and readily ascertainable on a real-time basis, it may be appropriate to grant exemptive relief to permit purchases and sales of such bonds to be effected on a principal basis with a related party.

***Inter-Fund Trading* -** Industry participants have requested that the CSA grant exemptive relief from the current provisions that prohibit inter-fund transfers - i.e. the sale of securities owned by one investment fund managed by the investment fund manager to another investment fund managed by the investment fund manager or a related party. They have argued that these transfers are in the interests of both investment funds in that they may be effected at no brokerage cost on either the sale or the purchase of the securities and that to prevent such transfers is not in the interests of investors of either of the funds that potentially are parties to the trade.

They have suggested that any exemptive relief that is granted be made subject to conditions that:

(1) the investments in question conform with the investment objectives, policies and restrictions of the purchasing fund;

(2) the decision of the selling fund to sell the securities and the decision of the purchasing fund to purchase the securities must be arrived at independently;

(3) the securities in question must be liquid securities (i.e. readily marketable in a

recognized public market with there being a significant public float);

(4) the price at which the sale and purchase is effected is the closing market price on the day of the trade or, if no trading has occurred on that day, at the price that is the mid-point between the closing bid and ask prices;

(5) special reporting requirements would be applicable to any such trades and that this information would appear in summary form in the annual and interim reports of the respective investment funds, with full particulars being required to be filed with the Securities Regulator and to be made available to investors and others upon request; the special reporting requirements would be more detailed than what would be required under generally accepted accounting principles in connection with related party transactions.

These conditions are similar to the SEC requirements with respect to inter-fund trading.

Although there are concerns about inter-fund trading that have been identified by industry participants (and which are summarized below), I think that on balance it would be appropriate for the CSA to consider granting exemptive relief provided that:

(1) the recommendation contained in Section 19.10 is adopted with respect to there being a requirement that investment funds that propose to engage in related party transactions be required to have an independent board; and

(2) it is made a condition that:

   (i) each of the five conditions set out in the preceding paragraph is made a condition precedent to the completion of the inter-fund trade;

   (ii) the reason for the trade is included in the special reporting requirements referred to in clause (5) of the preceding paragraph;

   (iii) the transactions are settled for cash payments against prompt delivery;

   (iv) the independent board of the investment fund is required to adopt guidelines with respect to the parameters of any inter-fund trading which may be engaged in, which guidelines will be required to be published in the base disclosure document and in the annual report of the investment fund;

(v) the independent board of the investment fund will be required to review such transactions for compliance with the abovementioned conditions and guidelines;

(vi) the investment fund manager has established internal systems, controls and procedures for monitoring compliance with the conditions upon which inter-fund trading is permitted, the adequacy of which has been favourably reported on by the external auditors of the investment fund manager and are satisfactory to the independent board;

(vii) the external auditors of the investment fund periodically review all inter-fund transactions that the investment fund has been a party to and report to the independent board as to whether the transactions have been completed in accordance with the conditions and guidelines upon which inter-fund trading is permitted and, if not, outlining the particulars respecting non-compliance with the conditions and guidelines; and

(viii) the special reports referred to in clause (5) of the preceding paragraph will include: (i) a report of the investment fund manager certifying that the transactions have been completed in accordance with the abovementioned conditions and guidelines or, in the event that they have not, specifying what action has been taken to remedy the non-compliance and to protect against the recurrence of such non-compliance, and (ii) a certificate signed by or on behalf of the independent board as to the board's review of the transactions and any action taken by the board with respect to the same.

It is my understanding that in considering whether inter-fund trading should be permitted, the CSA has been thinking of it in the context that inter-fund trading would be an exception

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I believe that there is a need for the independent board to adopt guidelines with respect to the parameters of any inter-fund trading in view of the numerous concerns about some of the purposes of inter-fund trading as outlined under the heading "Concerns About Inter-Fund Trading.

to the manner in which portfolio transactions for an investment fund are normally executed. If this should be the CSA's continued expectation, I think that this needs to be stated in outlining any basis on which inter-fund trading may be permitted.

Further work needs to be done with respect to the type of special reporting requirements referred to above, the content of such reports, the duties of the independent board and the extent of the internal and external verifications that are required with respect to the matter. I suggest that this be done as part of the follow-on work arising from this report. However, in doing this, it should be kept in mind that it is fundamental to my recommendation to permit inter-fund trading, that there be an independent board that is responsible for establishing the guidelines with respect to the parameters of any inter-fund trading that may be engaged in and for monitoring what is happening.

Concerns About Inter-Fund Trading

Among the concerns that were expressed to me about permitting inter-fund trading were concerns relating to (i) transfers being effected to smooth out performance results; (ii) transfers being effected to raise cash to fund redemptions rather than sell securities that may not be liquid or may result in depressing the market price; (iii) transfers to realize capital gains or losses to affect performance results; (iv) transfers to eliminate or smooth out the receipt of interest or dividend income or to avoid flow-through treatment of such income by transferring securities to a corporation or to a non-taxable managed account; (v) the fact that for transfers that are effected at the mid-point of the closing bid and ask prices, the selling fund will receive less than the ask price and the purchasing fund will pay more than the bid price and these amounts differ from what the selling fund and the purchasing fund would have received or paid if the securities had been sold or purchased in the market at the respective ask and bid prices, (vi) questions about the appropriateness of using the closing bid and ask prices to establish a fair market value when these prices may not reflect what the bid and ask prices would be for the size of the order in question, (vii) transfers of illiquid securities to pension funds managed by the investment fund manager to raise cash and to realize gains at higher market values than could be realized if the securities were sold in the market; (viii) the fact that market transactions may be effected by the portfolio manager or a related party at the end of the day that will affect the closing sale price or the closing bid and ask prices; (ix) artificially maintaining market prices; (x) making markets less liquid because of reduced availability of the market float;

and (xi) the risk of a class action if the net asset value of the investment fund decreases.

These concerns are not insignificant. While I think that the conditions outlined above as a basis for permitting inter-fund trading go a long way to manage the concerns, they are not a complete answer to them and it therefore becomes a matter of judgment as to whether, when, in what manner and to what extent such trading should be allowed.

19.12 Exemptive Relief - Investment in Securities of Related Parties

The intention of the current regulatory regime is that if a portfolio manager manages money on a discretionary basis, it should not be able to cause the managed funds to invest in securities of related parties, whether the relationship is "upstream" or "downstream" or "horizontal".

Exceptions for Certain Bank and Trust Deposits

I think that it would be appropriate to provide for exceptions to this rule with respect to bank or trust company deposits which meet certain criteria such as investment grade ratings, terms that are no less favourable than those that are available to third parties and issuer diversification. It should be a condition of any such exception that:

(1) records be kept documenting the relevant information required to establish compliance with the foregoing criteria; and

(2) the entity with which funds are deposited be regulated by OSFI.

Exceptions for Certain Issuers When the Related Party Has No Access to Investment Decisions

The current exception to the abovementioned restriction that permits a "dealer-managed mutual fund" (as defined in National Policy No. 39) to invest in securities of an issuer where a related party is a director or officer or employee of the issuer: (i) if the related party does not participate in the formulation of investment decisions made by the portfolio manager, (ii) does not have access prior to implementation of investment decisions made by the portfolio manager, and (iii) does not influence the investment decisions made by the portfolio manager, should continue to apply and should be extended to all investment funds. However, there should be requirements to demonstrate the foregoing and for there to be measures in place to see that these conditions are adhered to.

For the reasons outlined in Section 19.08, I do not think that structural and functional separation are by themselves a sufficient basis on which to grant exemptive relief but they may be relevant in determining whether responsible persons have access to material information about either the issuer or the investment program of the investment fund, as the case may be.

Exceptions Where Securities of a Related Party are Included in an Index

Where the securities of an issuer that is a related party are included in a liquid (i.e.

actively-traded) recognized exchange-traded index security such as the Toronto 35 Index known as "TIPS", this should not preclude an investment in such securities by an investment fund.

Exceptions Where an Issuer Becomes a Related Party Subsequent to an Investment Fund Acquiring its Securities

I do ***not*** recommend that any ***blanket relief*** be granted from the provisions of securities legislation that require an investment fund to divest itself of securities of related parties. Instead, I recommend that the situation continue to be looked at on a case-by-case basis. In this respect, I suggest that in the course of such case-by-case review, consideration may be given to not requiring divestiture where the securities of a related party are securities of a major issuer whose securities represent a significant portion of the market capitalization of the principal market in which its securities are traded, the securities are widely-held and are readily marketable.

Conditions that limit the aggregate amount that may be held by any one investment fund or by all investment funds or managed accounts within the group may also be appropriate.

In situations where it is decided that it is not appropriate to grant exemptive relief from the divestiture requirements, I suggest that consideration be given to enabling the securities held by the investment fund to be disposed of in an orderly manner over a reasonable period of time.

In considering whether to grant exemptive relief, consideration should be given to whether the investment fund may, by reason of being deemed to be an insider of the issuer and in a special relationship to the issuer, be prevented from readily disposing of the securities of the related issuer in the event of there being undisclosed material information about the issuer as this will go to the issue of liquidity.

For example, see Section 111(3) of the Securities Act (Ontario).

19.13 Exemptive Relief - Participation in Related Party Underwritings

Financial institutions have requested the CSA to grant exemptive relief from the various provisions of the securities acts and of National Policy No. 39 that restrict the investment manager of an investment fund from investing in securities (other than those issued or guaranteed by the federal or a provincial government of Canada or their respective agencies) for which a related party has acted as an underwriter in the distribution of such class of securities of the issuer for a period of at least 60 days following the conclusion of the distribution of the underwritten securities to the public.

The reasons for making this request relate to the deregulation of the financial services industry and to the arguments that: (i) the current regulatory regime is no longer appropriate, (ii) investors in proprietary funds of these financial institutions are being adversely affected by the restrictions, and (iii) the rules should be changed, all as more particularly outlined in Section 19.02. Financial institutions have argued that structural and functional separation between the portfolio manager and the related parties, either alone or together with rating, liquidity and size limitations, should create a sufficient degree of independence to permit a portfolio manager to engage in transactions with related parties that would otherwise be prohibited. These arguments are outlined in more detail in Sections 19.08 and 19.09.

I share the concerns expressed by the industry participants whose concerns are outlined in Sections 19.08 and 19.09. In addition to these concerns, industry participants have commented that it is better to miss out on some good deals rather than to get in on the bad deals. They have pointed out that in underwritings, deals are priced to take the risk out of the deal for the dealer and that such underwritings by a dealer/affiliate do not belong in an investment fund that is managed by a party that is related to the underwriter. Such underwritings are inconsistent with the basic premise that an investment fund is expected to be ***independently*** and professionally managed.

It has been observed that the benefit of the "60 day period", which historically is derived from IDA requirements, is that by the end of this period, the market will have absorbed the issue and any market stabilization activities will have been concluded.

It has been noted that maintaining the restriction may encourage the continuation of there being diversified sources of supply of product being available from independent underwriters.

Recommendations

In view of the foregoing concerns and comments, I do not recommend that the CSA grant exemptive relief to permit participation in related party underwritings.

In addition, I recommend that the restrictions should apply to all investment funds (as opposed to applying only to dealer-managed mutual funds) and to all underwritings regardless of whether they are firm commitments or are based only on best efforts.

I also recommend that the exception to the current restriction that applies if the related party is participating in the underwriting only as a member of the selling group distributing 5% or less of the securities that are underwritten be eliminated as it is inconsistent with the basic principles.

If the CSA were to decide that exemptive relief should be granted notwithstanding the concerns outlined above and the recommendations that I have made, I suggest that the basis on which such relief be granted should include conditions that would:

(1) limit the percentage of a related party underwriting that can be bought for all accounts managed by related parties to a maximum specified percentage - the suggestions made to me ranged from 1 per cent or 2 per cent up to 10 per cent;

(2) limit the percentage that any one investment fund (account) can acquire to something less than the current "10/10 rule";

(3) provide that the investment fund's (account's) purchase be conditional on the whole issue being sold at the same price;

(4) limit the securities that could be acquired to securities of "seasoned issuers";

(5) limit the securities that could be acquired to securities of issuers that are not a connected or a related issuer;

(6) require the investment fund to have an independent board, whose obligation it is to represent the interests of the investment fund and to see that the transactions involving related parties are in the best interests of the investment fund and its investors;

(7) require the independent board to establish guidelines and monitor compliance with the guidelines and the above conditions; and

(8) require special reporting in the annual and interim reports along the lines outlined in Section 19.11.

19.14 Connected and Related Issuers

OSC staff has prepared a discussion paper and a request for comments concerning the conflicts of interest regime with respect to related and connected issuers that exists in Ontario, Alberta, British Columbia, Quebec and Nova Scotia. Among the reasons for this initiative are the requests by the bank-owned dealers to be relieved from the requirements to have an independent underwriter(s) involved in their underwritings of connected and related issuers as long as the prospectus clearly disclose the relationships and interests.

If the outcome of the public debate on these issues is that relief should be granted, I think that it becomes even more important that there be restrictions on the ability of related parties to place these underwritten securities in accounts over which they exercise discretionary management and to retain the "60 day" rule referred to in Section 19.13.

19.15 Securitizations

There is a need for the CSA to consider what restrictions, if any, should be placed on investment funds investing in securities that represent the securitization of assets of a

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(1994) 17 OSCB 5255

related party, whether such assets are loans, mortgages, accounts receivable or otherwise. While such securities may technically not be securities that would be covered by any of the present restrictions, the acquisition of these securities by a related investment fund (or other account) raises conflict of interest concerns that should be addressed.

As noted at the beginning of this report, the trend towards securitization is a means of transferring an institution's transactional risks to investors. Subject to any recourse provisions, securitization is a "win/win" situation for the institution which earns fees for: (i) originating the transaction and, in some cases, for distributing the securities, (ii) ongoing "servicing" or "administration" (which fees are often themselves securitized) with respect to the securitized assets, and (iii) investment advice when the assets are placed in managed accounts. In addition, with the risk of the transactions having been moved "off balance sheet", capital reserve requirements are reduced as are CDIC premiums. With the risks transferred to third parties, the institution is able to focus on generating as many transactions as possible to obtain immediate and ongoing fees and to continue its securitization program.

Discussions with industry participants were focussed on pointing out the potential conflicts of interest that would arise if an investment manager were to acquire securities representing securitizations of assets of related parties that are offered by related party underwriters but no suggestions were made about what should be done to regulate this area.

Recommendations

In my opinion, notwithstanding that the securities may be issued by a separate legal entity that may not technically be considered to be a related party, they are in substance the same as securities issued by a related party. Accordingly, it is my recommendation that securitizations be treated as though they are securities issued by a related party and that

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In his book, *Surviving the Coming Mutual Fund Crisis,* (Little, Brown and Company - 1994), John Christensen at page 92 poses the question: "Will the people who showed so little prudence in signing up mortgages in the 1980's, when they had ownership of those mortgages, now show *greater* prudence after the burden of risk has been passed off to someone else's shoulders, namely, yours? Not bloody likely".

they be subject to comparable prohibitions against an investment fund investing in such related party securities.

19.16 Mortgages - National Policy No. 29

The current regulatory approach (which is reflected in National Policy No. 29) to permitting mortgage mutual funds to acquire mortgages from a related party needs to be reviewed from the perspective of determining whether conflict of interest concerns are adequately addressed by the provisions of the policy. As exemptive relief is required to be granted in order for investment funds to acquire mortgages from related parties, it is appropriate that the conditions on which any exemptive relief may be granted be considered in conjunction with the review of the policy.

I recommend that this be part of the follow-on work resulting from this report and that in doing this work, the guiding principles outlined above be taken into account.

19.17 Are Certain Functions Incompatible With Other Functions?

The suggestions outlined in this Section 19 are all aimed at ***managing*** conflicts of interest rather than ***eliminating or reducing*** the number of instances in which they occur.

The complexity of managing these conflicts, the difficulty in overcoming negative perceptions that can exist no matter how meticulous an organization is in managing its conflicts, the possibility of becoming involved in litigation alleging breach of fiduciary obligations or otherwise raises the question of whether it would not be more productive to concentrate on eliminating or reducing the number of instances in which conflicts of interest can occur.

To do this would involve financial institutions and investment dealers aligning their business operations to separate:

(i) product-generation and investment banking/dealing functions and ownership, and

(ii) discretionary money management functions and ownership.

Enabling financial institutions to sell third party funds (which is one of the recommendations made in this report) could well be a factor that might contribute to the feasibility of financial institutions considering a strategy that is focussed on eliminating or reducing the number of instances in which conflict of interests occur.

20. EXECUTION OF PORTFOLIO TRANSACTIONS

There are some industry practices that have developed in connection with the execution of portfolio transactions in addition to those previously mentioned that raise issues that I think should be addressed by the CSA.

20.01 Use of Affiliates of the Investment Manager

Several investment fund organizations have established brokerage affiliates through whom all or a substantial part of the portfolio transactions for their sponsored investment funds are placed. These firms either execute the portfolio transactions directly (on an agency basis) or jitney them through another firm. The commissions generated by the portfolio transactions are retained by the firm and have become another revenue stream for the investment management organization. In addition, reciprocal business placed by others through brokerage affiliates of investment fund organizations generate additional commissions and spreads that are retained by the brokerage affiliate and add to the revenue stream of the investment management organization.

Publicity this summer about the use of brokerage affiliates to execute portfolio transactions for sponsored investment funds generated more calls to me from the public wanting regulatory action to "stop these conflicts" than I received from the public on any other subject. The public perception about this matter is extremely negative. However, some industry participants have told me that there are members of the public who do not share these negative views - at least as long as the investment funds are generating high total returns.

In talking with industry participants about the use of brokerage affiliates to execute portfolio transactions, I became aware that some portfolio managers have taken the approach that they have satisfied their fiduciary obligations to obtain "best execution" for the investment fund if the commission rate paid by the investment fund to an affiliated broker is no more than the "going rate" on the street. I believe that the adoption of this view is a relatively recent development and that its validity is open to question.

In this respect, it is my understanding that the term "best execution" refers to the obligation to obtain the most favourable terms available under the circumstances for a client's transaction. This obligation is based on the common law agency and fiduciary duty of loyalty, which obligates an agent or fiduciary to act exclusively in the client's best interest and to exercise reasonable care to obtain the most advantageous terms for the client. Determining what the most advantageous terms are involves the balancing of a variety of factors including price, volume, market, and the provision of research and statistical services. It requires the exercise of skill and judgement in choosing the dealer through whom and the market in which the portfolio transaction will be executed and that the skill and judgment be exercised by persons motivated only by the best interests of the investment fund.

The CSA has not articulated these standards in detailed rules as has been done in the United States, preferring to rely on the common law obligations of agents and fiduciaries. I favour this approach and would be reluctant to see it change. However, I think some action in this area is required to be taken by the CSA.

Recommendations

The simple approach would be that, in addition to the existing provisions that do not permit an investment fund manager to execute portfolio transactions through an affiliate on a principal basis, the investment fund manager should ***not*** be permitted to execute portfolio transactions through an affiliate on an agency basis. There is support for this approach from some industry participants who are of the view that there is no justification for executing portfolio transactions through a brokerage affiliate of an investment fund organization. They characterize the establishment of such brokerage affiliates as being "another grab for the consumer's pocket" ... "as being grossly wrong" ... "as adding no value whatsoever" and "... as being part of the attitudinal problems that plague the industry today".

If the investment fund industry were able to establish to the satisfaction of the CSA that there are substantial cost savings that can be realized for investors by brokerage transactions for sponsored investment funds being executed through a brokerage affiliate of an investment fund organization, another approach that could be considered by the CSA (assuming that it decides not to prohibit the use of brokerage affiliates of investment fund organizations to execute portfolio transactions for sponsored investment funds) is one that would:

(1) clarify the "best execution" obligation;

(2) require that records be kept that establish the factors that were taken into account in fulfilling the "best execution" obligation and the reason why the decision was made to place the order with the affiliated broker or dealer in question;

(3) require that if portfolio transactions are going to be effected through an affiliated broker or dealer, the investment fund must have an independent board with duties comparable to those outlined in Section 18.04;

(4) require detailed reporting of portfolio transactions executed through an affiliate to be filed with the Securities Regulator on a timely and public basis, with enhanced disclosure of the information in the investment fund's annual and interim reports; and

(5) require the net revenue from commissions generated by the portfolio transactions executed for the investment fund to be paid to the investment fund, with limitations on what expenses could be deducted in determining net revenue; in determining the amount to be paid to the investment fund, revenue derived from reciprocal business placed by others with the brokerage affiliate should be taken into account.

Of the two approaches, I prefer the first because I do not think that it is appropriate for investment fund organizations to use the assets of their sponsored investment funds to generate revenue streams for themselves over and above what they are paid as the

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Schedule Four to this report sets out an extract from a Statement of Additional Information of an American investment fund outlining the principles that form the basis for the decisions relating to the execution of brokerage transactions for the investment fund including what is meant by "best execution".

manager of the investment funds.

Notwithstanding this preference, if there are substantial cost savings for investment funds that can be realized by establishing an affiliated broker (which was the case in the days of fixed commissions but is no longer intuitively obvious), it would not be appropriate to prevent such savings from being realized. However, any such savings should belong to the investment fund and not to the investment fund manager or its affiliates.

20.02 Use of Electronic Trading Networks

During the course of my discussions with industry participants, I became aware of the fact that at least one investment fund organization has an ownership interest in an electronic trading network. Time has not permitted me to consider what the implications are, if any, of investment fund organizations having an ownership interest in electronic trading networks and of portfolio transactions for a sponsored investment fund being executed through such network. However, at first blush the issues appear to be analogous to those discussed above.

This is a matter that I recommend be considered as part of the follow-on work resulting from this report.

20.03 Executing Portfolio Transactions Through Distributors or their Affiliates

The sales practices and incentives described in Section 10.04 with respect to reciprocal commissions are another example of areas where the CSA needs to intervene unless the matter is handled in a satisfactory manner as a self-regulatory matter by the industry. Reference is made to Section 10.04 for my recommendations in this respect.

21. SOFT DOLLARS

Soft dollar arrangements apparently trace their origin, in the case of the United States, to the days prior to 1975 (1983 in Canada) when there were fixed rates of commissions that institutional investors regarded as being too high. Soft dollar arrangements were a means to allow commission discounts. With the elimination of fixed rates of commission, there would appear no longer to be either a need or any justification for soft dollar arrangements. The use of soft dollars gives rise to conflict of interest issues with respect to whether the investment manager and/or the brokers or investment dealers through whom the investment manager is executing portfolio transactions, are meeting their respective "best execution" obligations or whether they are benefitting at the expense of their respective clients to whom they owe fiduciary obligations. Questions of this nature do not contribute to the integrity of, or confidence in, the system.

While I have no sense from my discussions with industry participants that the use of soft dollar arrangements is significant in the context of the management of the investment portfolios of investment funds, I did not focus in depth upon this subject and the practices may be more prevalent than I understand them to be.

There are two types of soft dollar arrangements that are relevant in the context of investment funds - third party research-related soft dollar arrangements and brokerage/service soft dollar arrangements.

21.01 Third Party Research-Related Soft Dollar Arrangements

The first type of soft dollar arrangements, which is referred to as a "third party research-related soft dollar arrangement", refers to the practice by which an investment adviser (which term includes a portfolio manager) uses client commission dollars to obtain research-related services from someone other than the broker or dealer that is executing the soft dollar trade.

In an article entitled *Soft Dollars: The Pension Industry's ‹Dirty Little Secret›* contained in the August 1994 issue of Pension World, Mr. M. Steve Yoakum, Executive Director of the Missouri State Employees' Retirement System, is quoted as saying: "Potentially, it's an area that could lead to a scandal ... soft dollars are the dirty little secret in our industry." The article goes on to state:

> "According to Mr. Yoakum, plan sponsors tend to avoid talking about soft dollars because they often use them to obtain off-budget services or equipment other than research, such as computers, they might not be able to get normally. Brokers don't want to discuss soft dollars because they tend to make more money on these types of transactions, and money managers don't want to talk because they inevitably use research purchased by one client to also benefit another".

I would like to emphasize that the comments in this Section are not directed at decisions to allocate portfolio transactions to brokers or dealers on the basis of the proprietary research that such brokers or dealers

Third party research-related services involve the purchase by a broker or an investment dealer of various services and products, including research reports, publications, statistical services, electronic data and performance measurement services, for the investment adviser in consideration for the commitment to execute brokerage transactions through the broker/investment dealer that will provide the broker/investment dealer with a guaranteed amount of commissions or order flow. The choice of the brokers/investment dealers through whom the portfolio transactions can be executed is usually limited to not more than three brokers/investment dealers but is sometimes limited to only one broker/investment dealer. To get "credit" against the investment adviser's commitment, the investment adviser is required to declare at the time of placing the order that it is a soft dollar transaction.

These arrangements give rise to many questions including:

(1) Are the arrangements for the benefit of the clients or for the benefit of the investment adviser?

(2) Is it appropriate for arrangements that benefit the clients also to include benefits to the investment adviser?

(3) If all of the clients of the investment adviser have not authorized or requested the investment adviser to enter into third party research-related soft dollar arrangements:

(i) Are some clients benefiting at the expense of others?

(ii) Are some clients incurring additional costs?

Problems in this area relate to the pooling of orders for clients which I understand is the generally agreed fairest way to handle multiple client orders where some

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provide to their clients. The problem area that is being addressed in Section 21.01 is when a broker or dealer pays out "hard dollars" to a third party to supply research-related data or services to a client.

clients may be selling securities and other clients may be buying the same securities.

(4) Are clients paying for more services than they need?

(5) Are clients paying too much for the services that are being provided - e.g. are the service providers charging more to soft dollar customers than they are to cash customers for the same services?

(6) If the broker/investment dealer and the investment adviser are related parties, is the investment adviser conferring a benefit on the broker/investment dealer by committing to execute brokerage transactions through the broker/investment dealer that will provide the broker/investment dealer with a guaranteed amount of commissions or order flow?

(7) If the service provider whose fees and expenses are paid through soft dollar arrangements is related to the investment adviser and/or the broker/investment dealer, is the investment adviser conferring a benefit on itself and/or the related broker/investment dealer?

(8) Are brokerage costs higher than they should be?

(9) Are clients getting the best price available on their portfolio transactions?

(10) Are the arrangements providing the broker/investment dealer with the opportunity to engage in riskless principal trading on the other side of the transaction?

With respect to the last three questions, I have been told that investment advisers generally give the "easy trades" in payment for the research soft dollar commitments - e.g. inter-listed, highly liquid stocks - which makes it easy for the broker/investment dealer to conceal its strategy. If so, the ultimate cost to a client may not be more but the client may be under the illusion that it is receiving something for nothing.

21.02 Brokerage/Service Soft Dollar Arrangements

The second type of soft dollar arrangement, which is referred to as a "brokerage/service soft dollar arrangement", refers to the practice of a broker or investment dealer agreeing to pay the custodian fees or registrar and transfer agency fees of an investment fund in exchange for the commitment to direct a minimum amount of brokerage to the broker/investment dealer. The investment manager of the investment fund usually negotiates the terms of the contract with the service provider who is paid directly by the broker/investment dealer.

A recent SEC proposal on the reporting of investment fund expenses paid for through directed brokerage arrangements states that brokerage/service soft dollar arrangements generally do not give rise to the same concerns that third party research-related soft dollar arrangements do because they usually involve the use of the investment fund's commission dollars to obtain services that directly and exclusively benefit the investment fund.

While this statement may be true in general terms, I think that virtually the same questions that arise with respect to third party research-related soft dollar arrangements arise with respect to brokerage/service soft dollar arrangements.

For example, the fact that operating expenses are paid by third parties can result in benefits to the investment adviser and its affiliates that flow from the reduction of the management expense ratio of the investment fund. This reduction may increase revenues from managing the investment fund by: (i) encouraging higher sales of securities of the investment fund which increases the net asset value on which the investment manager's compensation is based, and (ii) reducing the amount of any expense waiver or reimbursement commitment that has been given.

Most, if not all, investment advisers advise many clients, including, in the case of an investment fund manager, other sponsored investment funds. If not all of the clients have authorized the entering into of these brokerage/service arrangements, the same problems as outlined above arise with respect to the pooling of client orders.

The same questions as to whether the costs of the portfolio transactions are higher than they should be and whether the prices at which the portfolio transactions are effected are

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See SEC Release No. 33-708 - Payment for Investment Company Services with Brokerage Commissions - Footnote 1 on page 3.

as good as they should be, arise.

21.03 Range of Services and Products Available Through the Use of Soft Dollars

I understand that some brokers and investment dealers have a virtually limitless catalogue of services or products that they will provide on a soft dollar basis. These range from the third party research-related services referred to above through to the provision of computers, cellular phones, office supplies, telephone services, legal services and medical services. According to an article in Business Week, there are 581 services available through one Wall Street brokerage firm and the going rate is $1 of free service for every $1.60 in commissions.

The situation is reminiscent of the free products you could once get from grocery stores based upon your aggregate purchases and today's equivalents thereof which are the frequent flyer programs and the "savings" that you seemingly achieve through the use of store/product discount coupons or other discount programs. All of these situations give rise to the once prevalent public debates about whether you are really getting something for nothing or whether you are simply paying more for everything to support the "freebies" for others.

21.04 The Role of Performance Measurement Service Providers

I have been told that the pressure to enter into soft dollar arrangements is coming from consultants who need arrangements of this nature to have their fees paid to ensure that clients will continue to retain them to provide performance measurement services and to evaluate the services that clients receive from their investment advisers.

I understand that consultants convince clients that they cannot trust the portfolio measurement information provided to them by their investment advisers and that they need the services of an independent third party and that the consultants' services can be provided to them at no cost to them - i.e. their services are free - everyone else is doing it so "why aren't they".

Dangerous Liaisons - Business Week - October 3, 1994 - page 110.

Clients (i.e. fund managers) like the fact that the costs are "off budget" - it makes their expense ratios look better and those employees or other personnel who are in charge of managing expenses get rewarded based on the cost savings that they have effected. No one traces through the transactions effected on a soft dollar basis to see if in fact too much was paid for the securities or if the securities were sold for too little or if too much was paid by way of brokerage commissions or spreads.

The same consultants who provide these performance measurement and valuation services are often the ones who select the investment advisers who are asked to present tenders to manage accounts for the clients in question. I am told that if an investment adviser is not prepared to enter into soft dollar arrangements, the investment adviser will never make it to the list of persons invited to tender or, if invited to tender, will never make it to the "short list".

I understand that in some cases these consultants are direct competitors with the investment advisers by reason of the fact that they directly or indirectly act as investment advisers for managed accounts. In this respect, I also understand that if the consultants decide to recommend that the investment adviser of a managed account be changed and the client agrees, the consultants often take on the management of the managed account at least during the period pending the retaining of a new investment adviser and receive fees for doing so.

The consultants generally receive a fee or commission rebate for administering the soft dollar arrangements which, I understand, is equal to 20% of the brokerage commitments. I understand that this fee or commission rebate is paid to the consultant by the broker/investment dealer either separately or as part of a commission rebate program. Consultants generally are not registered as a broker or investment dealer under applicable securities legislation. Accordingly, regardless of how the fee is paid, it amounts to splitting commissions between a registered and unregistered dealer if the consultant is not registered as a broker or investment dealer under applicable securities legislation.

Arrangements of this nature also give rise to the question of whether the consultants are receiving undisclosed payments from other service providers to the managed accounts in consideration for the managed accounts dealing with them.

21.05 Current Regulatory Response

Currently there are policy statements that restrict third party research-related soft dollar arrangements to "investment decision-making services" and to "order execution services" and require disclosure to be made to the securities authorities in Ontario and Quebec and, on request, to the beneficiaries of the managed account. In the case of investment funds, the policy statements, in addition to the foregoing, restrict the use of reciprocal commissions and require disclosure of the arrangements with estimates of the amounts paid to be made in the annual information form or prospectus of an investment fund. The disclosure requirements contained in the current policy statements do not address the amounts reflected in the dealer "spreads" in the case of principal transactions and brokerage/service soft dollar arrangements are not expressly addressed.

21.06 Proposed Regulatory Response

In my opinion, the potential conflicts of interest inherent in relationships of the nature described in this Section 21 raise many questions, the existence of which do not contribute to confidence in the integrity of, or the way in which, the capital markets operate.

Although I believe that many people share this view and would like to see an end to the practices which have been outlined, there is a small but powerful segment of the capital markets that benefit from these arrangements and they do not want to see an end to the practices. There are also many people on the client side who think that they are getting something for nothing and see no reason why they should not be able to continue to do so. Few people welcome additional accountability with respect to their own performance.

Regulators are left in a difficult position. If they do nothing, and the practices are exposed as a scam or as the industry's "dirty little secret", as characterized in the August 1994 Pension World article referred to in the introduction to Section 21, the first question will be: "Where were the regulators"? If the regulators try to prohibit the practices or to regulate them, they will immediately be accused of over-regulation or unduly intervening in the operation of the capital markets or acting beyond their authority. None of these situations is desirable.

The regulatory options include:

(1) Do nothing.

(2) Prohibit soft dollar arrangements. - Many industry participants recommended that soft dollar arrangements should simply be prohibited.

(3) Publicize the concerns about soft dollar arrangements. - It was suggested to me that if the concerns and information about soft dollar arrangements are publicized enough, the practices would stop. The analogy that was used was that of smoking. If you make enough noise about the harmful effects, make it impossible to smoke without facing hazard warnings and make it very difficult to find a place where you are permitted to smoke, eventually this will reduce the incidence of smoking or at least make it socially unacceptable.

(4) Encourage the unbundling of commission rates. - If clients (including in the case of investment funds, the investors in such funds) become aware that even with negotiated commission rates, the rates might still be too high or are sufficiently high that they allow for commission rebates, perhaps they will bring increased pressure to lower these rates or at least to unbundle them into a research component and an execution component.

(5) SRO Regulation. - Consideration could be given to including soft dollar arrangements in the list of business practices to be regulated by the SRO.

(6) Include restrictions on soft dollar transactions in the conditions of registration. - Consideration could be given to restricting registrants (regardless of the category of registration) from entering into either all or certain types of soft dollar arrangements.

(7) Enhance disclosure requirements. - Consideration could be given to requiring enhanced disclosure of any soft dollar arrangements that are entered into with cost quantification required to be given, including what the impact would be on the

management expense ratios if these costs had been paid in cash.

In addition, consideration could be given to requiring the prices at which portfolio transactions are executed to be justified in the context of whether "best execution" was achieved. This would include requiring disclosure by brokers and investment dealers of the off-setting transactions and disclosure of mark-ups and mark-downs where principal transactions are involved.

The fact that this is difficult or costly or requires prospectus-level certifications would hopefully discourage entering into the transactions in the first place.

(8) Require annual approval for soft dollar arrangements to be obtained. - In the case of an investment fund, consideration could be given to requiring that there be an annual review of the soft dollar arrangements by an independent board and the authorization obtained from such board to continue with the arrangements. In the case of other managed accounts, consideration could be given to requiring comparable review and authorization by the appropriate person(s).

(9) Take enforcement action. - Action could be taken to enforce the provisions of securities legislation that do not permit commission splitting with non-registrants.

(10) Establish performance measurement standards. - Consideration could be given to encouraging the establishment of standards for performance measurement that are required to be universally used and externally verified. Having valuations that are made in accordance with externally verified, uniform standards should increase

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While this approach has some merit, I have some reservations about it because it seems to me to mix-up revenue items with capital items. I query whether the effect of the increased or decreased capital costs of portfolio investments equals the dollar amount of an expense item charged against operating revenues.

See Section 24.01.

the confidence level of clients in portfolio evaluations that are performed by the managed account's investment adviser and remove the need for third party measurement.

Recommendations

For the reasons previously stated, namely that the conflicts of interest that exist in the soft dollar relationships described above do not contribute to confidence in the integrity of, or the way in which, the capital markets operate, it is my recommendation that soft dollar arrangements not be allowed. It is also my recommendation that concurrently with the disallowance of soft dollar arrangements, the CSA should encourage the establishment of standards for performance measurement that are required to be universally used and externally verified (as more particularly outlined in the recommendations regarding performance information set forth in Section 24.01) as this measure should address one of the main reasons why soft dollar arrangements are so prevalent today.

22. FUND OF FUNDS

The expression "fund of funds" or "fund on funds", as some people call such investments, refers to the investment by one investment fund (the "top fund") in the securities of other investment funds (the "bottom funds"). Fund of fund investments are currently restricted by National Policy No. 39 and have been restricted for many years prior to the adoption of National Policy No. 39. The main reasons why appear to relate to concerns over who is responsible for managing the top fund, whether accountability is too diffused, the excessive costs that are involved, the duplication of management fees and expenses, the impact on bottom funds and conflicts of interest.

Currently, the only fund of fund investments that are permitted under National Policy No. 39 involve funds that are under common management and have been qualified for sale to the public pursuant to prospectuses filed in the jurisdiction of the top fund, the arrangement avoids the duplication of management fees and sales charges, adequate provision has been made to address conflicts of interest and disclosure is made in the prospectus of the top fund. In addition, an investment fund is permitted to invest in Toronto Stock Exchange 35 Index Participation Units.

There is an exception from these restrictions in the case of certain funds that have been formed with the approval of foreign governments to facilitate investments in foreign countries.

Master-feeder funds, umbrella funds and multiple class corporate share conversion funds are sometimes referred to as being variations of the fund of funds structure. None of these variations is expressly dealt with

The approval of investors and of securityholders is required to be obtained if the top fund proposes to invest more than 10 per cent of its net assets in a bottom fund or if it proposes to hold more than 10 per cent of any class, or series of a class, of securities of a bottom fund.

Some industry participants have argued that the current restrictions are too restrictive and should be modified or eliminated. They see no reason why investments in other investment funds should be restricted, arguing that: (i) such investments enable an investor to diversify his or her assets more extensively than the investor can by investing in one fund, (ii) there are no conflicts of interest that cannot be managed by the investment manager, having regard to the interests of all of the investment funds that are subject to its management, (iii) a fund of fund structure facilitates an efficient and tax-effective way of managing an asset allocation program, and (iv) a fund of fund structure provides the ability to offer a "wrap account" of investment funds and simplifies an investor's choice of investment funds.

The CSA considered this matter in the late 1980s and draft proposals for modifying the fund of fund restrictions were published for comment. Some industry participants did not feel that the proposals went far enough in relaxing the restrictions. Some CSA members were concerned that the proposals perhaps went too far and many people (both from the industry and from the CSA) thought that the proposals were too complex and perhaps did not address the real issues.

While the matter was worked on during the intervening years, no mutually satisfactory resolution was able to be achieved. As an interim measure, exemptive relief was granted on a case-by-case basis to several applicants to permit them to proceed with certain asset allocation programs.

In talking with industry participants about what should be done about fund of fund investments, I found that there was no consensus. As was the case in the 1980s, many people felt that the provisions were too restrictive. They thought the restrictions should

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in National Policy No. 39.

be relaxed or eliminated, that the fund of funds structure lent itself well to use as a means of implementing asset allocation models, of minimizing capital gains taxes and for creating a "wrap account" of investment fund securities. I did not sense that there had been much focus on how the investment manager could treat all investors in all funds involved in the fund of fund structure fairly. It was just assumed that the investment manager would be able to do so.

An almost equal number of people felt that fund of fund investments should not be allowed, expressing the view that such investments open the investment fund area to abuse in so many ways, including favouring the interests of the investors of one fund over the interests of investors in another fund, the ability to move assets around without regard to the interests of the remaining investors in the underlying funds and the ability to provide an illiquid fund with liquidity. The view was expressed that there is not anything that can be done with a fund of fund structure that cannot be done directly and that a fund of funds structure does not give the investor any benefits that the investor can not otherwise obtain. It was suggested that if there is a benefit to an investor in a fund of fund structure, someone else will be paying for it. Several people expressed the view that every fund of funds involves incremental expenses and higher expense ratios. With respect to the use of a fund of funds structure to implement asset allocation models, several people observed that it was preferable that the allocation be done on an individual basis at the point of sale rather than using a fund of funds structure and that there was no need for such a structure.

I have been told that the "perceived" benefits of some of the current variations of fund of fund structures may not in fact exist and that investors are perhaps being misled by marketing material that holds out that there are such benefits.

There are also some people who regard the ability to create a fund of funds structure as a marketing issue only and argue that there should be no regulatory intervention; that the market should be allowed to innovate. It has been suggested that an investment fund organization should be able to use a fund of funds structure to get new funds up and running until they are viable on their own.

Recurring questions expressed by virtually everyone that I talked to include the following:

- What problems does a fund of funds structure give rise to?

- What are the risks involved in a fund of funds structure?

- Why have fund of funds investments been restricted in the past?

- What are the concerns that the present restrictions are trying to address?

Although I was involved in the late '80s in the preparation of the draft proposals for amending the fund of funds provisions, I am not aware of any in-depth research that was done to identify the answers to these questions.

In addition, although conflicts of interest were identified as being a major issue to be addressed in the approval of any fund of funds proposals, the focus seems to have related more to concerns about conflicts that might exist with respect to the interests of investors in the top fund rather than with respect to conflicts that might exist with respect to the interests of investors in the bottom funds.

Recommendations

Need for Research

Before the CSA can meaningfully address fund of funds issues, there is a need to research the issues thoroughly, reviewing in particular the history leading up to the imposition of comparable restrictions in other countries as well as in Canada.

I recommend that this research also include a review of whether there are any issues related to an investment fund investing in closed-end investment funds. In this respect, I note that there used to be a provision that restricted such investments but it was deleted several years ago with perhaps not enough focus on, or understanding of why, the restriction had been included in the first place.

Conflicts of Interest

In considering conflict of interest concerns and how to address them, the interests of investors in the bottom funds need to be considered as well as the interests of investors in the top fund.

Potential Fund of Funds Problems with Other Structures

Master-feeder funds, umbrella funds and multiple class corporate share conversion funds involve elements that give rise potentially to comparable concerns that exist with respect to conventional fund of funds structures. For example, it was pointed out that in the multiple class corporate share conversion structures that are currently being offered, instead of providing the opportunity for significant tax savings, these multiple class corporate share conversion structures may produce inequitable treatment for all participating investors because of the triggering of capital gains to fund redemptions to effect conversions between share classes. Therefore, I suggest that there is a need to proceed cautiously with respect to permitting any of these offerings until there has been a thorough analysis of and understanding of the issues that they present.

I understand that the capital gains refund mechanism in the Income Tax Act (Canada) does not apply to shelter the remaining investors in the class from the need to distribute the capital gains triggered by the sale of portfolio securities to effect share conversions. Accordingly, if massive switches occur in one underlying fund to another, the remaining shareholders may receive excessive capital gains dividends. I further understand that Revenue Canada has indicated informally that it will not regard the conversion of one class of shares to another by investors in a fund of funds structure as a redemption for the purposes of the Income Tax Act. I also understand that some industry participants have questions as to whether the Income Tax Act permits the exchange of one class of shares of an investment fund for another class of shares of such fund on a tax-free basis.

The result of this recommendation is that market-driven innovation may well be held up in the short term. In my opinion, this is preferable to a situation where it turns out that investors' interests have been adversely affected by such market-driven innovation. Hopefully, if the recommendations outlined in Section 4 are implemented, the fact that securities regulation of investment funds will be centralized in one place, with persons who have the requisite expertise, ability and credibility to identify, evaluate and make decisions in a timely manner on the regulatory issues affecting investment funds, this should result in the process of assessing the merits of innovative offerings being able to be completed more expeditiously than has been possible to date.

Need for Priority

Many industry participants are frustrated by the present situation with respect to fund of funds and would like to see the issues concerning these funds resolved, particularly in the context of whether there are any regulatory concerns about the other structures referred to under the heading "Potential Fund of Fund Problems with Other Structures".

CSA staff has tried on several occasions to address, and to seek industry help in addressing, the fundamental issues raised by fund of fund structures, but despite the good faith efforts of all concerned, the fundamental issues still remain - unidentified and unaddressed.

Accordingly, I recommend that priority be given to researching this matter.

23. MONEY MARKET FUNDS

Money market funds are investment funds that invest in "money market securities" which are generally considered to be high-quality, short term debt obligations. Such funds are usually offered at a constant net asset value, which in Canada is generally set at $1 or $10 per unit.

There have been numerous and lengthy discussions among industry participants, IFIC and the CSA about the criteria that an investment fund must meet in order to be described as a "money market fund".

Money market funds were originally permitted to be offered in Canada at a constant net asset value on the basis that: (i) the maturity of the portfolio securities would be kept very short, (ii) all income would be distributed daily, and (iii) all transactions would be considered to be on income account for tax purposes.

The combination of these three factors results in the actual net asset value remaining the same as the constant net asset value because the cost and the market value of such short-term portfolio securities are considered, under generally accepted accounting principles, to be the same.

Over time, some investment funds that called themselves "money market funds" (but in reality were short-term income funds) lengthened the maturity of the debt obligations held in their investment portfolios but continued to sell and redeem the units of their funds at the stated constant net asset value notwithstanding that the cost and the market value of their portfolio securities were no longer necessarily the same. In addition, such funds did not treat their portfolio transactions as being on income account for tax purposes thereby giving rise to the problems with respect to distributing on a daily basis all realized and unrealized gains and losses on investment. It is this situation that has given rise to the questions and concerns about whether the actual net asset value of these funds is more or less than the constant net asset value of these funds ($1 or $10) at which the units of these funds are being sold and redeemed and to the other questions discussed in Section 23.03.

To deal with these questions, IFIC has proposed a definition of a money market fund that would modify the current definition of this term by requiring that the portfolio of a money market fund have a dollar-weighted average term to maturity not exceeding 90 days and that all portfolio securities of the investment fund mature within 365 days. IFIC proposes that the existing requirements with respect to the investment quality of the portfolio securities would continue to apply and that provision would be made to require that the portfolio securities be marked-to-market at least once a week or immediately if the Bank of Canada rate moves by more than 1/2 of 1 per cent. IFIC has also proposed that if the market value deviates by 0.5 per cent from the stated amortized cost value, the investment fund manager must cause the investment fund to take such action as is necessary to eliminate or reduce such deviation.

The IFIC proposals also recommend that changes be made in the manner that the effective yield of a money market fund is required to be calculated. In addition, the IFIC proposals recommend that instead of referring to such yield as being the "effective yield", the yield be referred to as the "compound yield". IFIC considers that this change in nomenclature may assist investors in better understanding the intention of such calculation.

23.01 Term to Maturity

The current definition of a money market fund is contained in Section 16.01 (iv) of National Policy No. 39.

I note that if this objective is to be met, there is a need to explain this difference in the marketing and distribution materials that are used in connection with the investment fund.

I understand that there is general agreement among industry participants and the CSA with IFIC's proposals to limit the dollar-weighted average term to maturity of a money market fund's investment portfolio to a maximum of 90 days and to require that all portfolio securities of the investment fund mature within 365 days. Accordingly, I recommend that these changes in the definition of a money market fund be implemented without delay. In addition, I suggest that the recommendations contained in Section 23.04 be implemented without delay.

23.02 Should a Money Market Fund Maintain a Constant Net Asset Value?

With respect to the other proposals made by IFIC, there are some questions that I think need to be addressed before determining whether to implement such proposals.

The fundamental question is whether the current practice of allowing a money market fund to issue and redeem its units at a fixed price - i.e. maintain a constant net asset value - should be continued, or should a money market fund be required to issue and redeem its units at the current net asset value thereof, as is required in the case of other open end investment funds?

Some industry participants have suggested that the current practice of allowing a money market fund to issue and redeem units at a constant net asset value is contributing to the reported lack of awareness by investors that money market funds are not guaranteed as to principal and are not covered by deposit insurance.

In addition, concerns have been raised about whether the practice of some investment managers of making capital contributions to a money market fund or purchasing assets of a money market fund in order to maintain a constant net asset value is creating unrealistic investor expectations that the investment manager will in fact guarantee the dollar amount of the investors' investments in the money market fund.

The concern is raised about what will happen if an investment manager is either unwilling, or does not have the resources that are required, to maintain the constant net asset value? If a financial institution is the investment manager of the money market fund or is a related party to the investment manager, are transactions of this nature giving rise to an expectation that there will be some sort of government guarantee?

Concern has been expressed that the public may come to rely on the fact that the investment manager will take whatever action is necessary to maintain the constant net asset value and that problems could result if an investment manager does not take, or is not able to take, the action necessary to maintain the constant net asset value.

Concern has also been expressed about the possibility of the investment manager permitting units of a money market fund to be issued and redeemed at the constant net asset value when, in fact, the actual net asset value of the units of the fund is different and there will be an adverse effect on investors.

The concerns that have been raised merit serious consideration. Prima facie, the problems (both those referred to above and those referred to in Section 23.03) that can result from the desire (which is marketing-driven) to issue and redeem units at a fixed price - i.e. at a constant net asset value - could lead to the conclusion that the practice should be discontinued, with the result being that money market funds would be required to be valued on at least a daily basis, with all issues and redemptions of units being effected at the actual net asset value thereof. However, I am told that investors like the simplicity of the fixed price and that it would be better to focus attention on how to ensure that the constant net asset value and the actual net asset values are the same rather than on not permitting money market funds to be offered at a fixed price. I agree with this perspective.

Therefore, I think that there should be further opportunity for informed dialogue among industry participants, the CSA and the other relevant regulators about the underlying issues that have been raised and the risks, if any, that they pose to the integrity of the capital markets

I suggest that this be part of the follow-on work arising out of this report.

23.03 Other Questions about IFIC's Proposed Amendments re Money Market Funds

Other questions which arise in connection with IFIC's proposed amendments concerning money market funds include the following questions.

(1) Should the constant net asset value of a money market fund be required to be set at $1 as is the case in the United States to facilitate the "penny-rounding method" of pricing and should the penny-rounding method of pricing be adopted in Canada? Some industry participants are of the view that the answer to both of these questions should be "yes".

(2) Should the investment portfolio of a money market fund be required to be marked-to-market on a daily basis or is it sufficient that it be marked-to-market at least once a week or immediately if the Bank of Canada rate moves by more than 1/2 of 1 per cent?

(3) If the net asset value of the investment fund deviates from the stated amortized cost (i.e. from the $1 or $10 constant net asset value), at what level or levels of deviation should action be required to be taken? Some industry participants think that the 0.5 per cent deviation that IFIC has proposed is too high and that corrective action ought to be taken at an earlier stage. In this respect, it was recommended that as soon as the deviation of market value to amortized cost exceeds 1/10th of 1 per cent, the investment portfolio should be required to be marked-to-market daily until such time as the deviation has been reduced to, and has remained at, less than 1/10th of 1 per cent for a period of one week. It was recommended that corrective action be required to be taken if the deviation of market value to amortized cost is

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These questions are based on the assumptions that money market funds are using, and will continue to use, the amortized cost basis for valuing its portfolio securities and are maintaining, and will continue to maintain, a constant net asset value.

Regulation 270.2a-7 (11) made under the Investment Company Act of 1940 defines the "penny-rounding method" of pricing as meaning the method of computing an investment company's price per share for purposes of distribution, redemption and repurchase whereby the current net asset value per share is rounded to the nearest one per cent.

3/10ths of 1 per cent or higher.

(4) If the net asset value that has been determined by marking the investment portfolio to market is more or less than the constant net asset value, what corrective action, if any, should be required to be taken?

(5) What disclosure should be required to be made to investors of the fluctuations in actual net asset value and of the action taken as a result of such fluctuations? When should such disclosure be required to be made and how should such disclosure be required to be made?

(6) Should the money market fund be permitted to continue to issue and redeem units of the money market fund at the constant net asset value at a time when its actual net asset value is either more or less than the constant net asset value?

(7) What happens in the event of a capital loss of a money market fund that results in the net asset value of the money market fund being below the constant net asset value?

(8) Should any corrective action that is taken be required to be effected through the income account, as opposed to the capital account, of the investment fund?

(9) If the answer to question 8 is "yes", what happens if the fluctuation in net asset value exceeds the undistributed year-to-date income?

(10) Should there be any restrictions on an investment manager's ability to contribute capital to a money market fund or to purchase assets of a money market fund in order to maintain a constant net asset value?

(11) Are investors misled by the publication of an effective rate of return - i.e. a compound rate of return?

Reference is made to the concerns outlined in Section 23.02 about this matter.

The suggestion has been made that many investors are misled by the publication of an effective rate of return in that they do not understand that this return does not correspond to the actual cash income they receive. It has therefore been suggested that the effective rate of return is not relevant to an investor and that what is relevant is information about what the current yield is and what the average term to maturity and/or the duration of the investment portfolio is.

(12) In calculating the effective rate of return, what is the appropriate compounding period?

The current provisions of National Policy No. 39 (and the comparable SEC requirements) require that the compounding period be seven days (i.e. 52 compounding periods in a year). The IFIC proposals provide that the compounding period be the average term to maturity of the investment portfolio. This latter period varies from fund to fund and perhaps even from day to day and within the same day.

I understand that the purpose of providing for a seven day compounding period is to achieve a uniformity of approach from the investor's point of view and to assist in comparing the effective yields quoted by the different money market funds.

(13) In calculating the yield of a money market fund, should net realized capital gains or losses be included or excluded? The current provisions of National Policy No. 39 (and of the comparable SEC requirements) require that they be excluded. The IFIC proposals provide for including net realized capital gains or losses.

I have been told that one of the reasons for excluding net realized capital gains or losses in calculating the yield is that these calculations can vary on a day-by-day basis and that including them could enable manipulation of the yield calculation as well as producing some anomalous fluctuations and volatility in the yield figures that are quoted.

In discussing this matter, some industry participants have queried why realized gains and losses are an issue with respect to money market funds when all transactions should be regarded as being on income account. This question would therefore appear to be the starting point for considering what the answer to question 13 should be.

(14) In view of the foregoing and of the difficulties involved in distributing gains and losses (realized and unrealized) on investments, should there be an express requirement that all transactions in a money market fund be treated as being on income account?

(15) Should any fund that is not a money market fund be permitted to offer its securities at a constant net asset value? In other words, should short-term income funds be permitted to offer their securities at a constant net asset value and, if so, what measures should be taken to ensure that investors are aware of the differences between such funds and a money market fund and between such funds and conventional investment funds?

(16) Should derivatives be permitted to be used in a money market fund? It has been suggested that derivatives have no place in a money market fund and that if derivatives are included in an investment fund, it should not be permitted to be described as a money market fund and it should not be permitted to be offered at a constant net asset value.

(17) Should all money market funds be required to note prominently that they are not insured by CDIC and that there is no guarantee on the amount of capital invested in the fund? It has been suggested that the answer to both of these questions should be "yes".

Some of the foregoing questions are difficult and, in the case of some questions there is no absolutely right or wrong answer. Ultimately, the CSA will have to exercise its best judgment about how to balance the different perspectives. However, before doing so, I think that it would be worthwhile for these questions to be addressed as part of the follow-on work referred to in Section 23.02 resulting from this report.

23.04 Additional Recommendations for Immediate Implementation

In order to protect the interests of investors pending the outcome of the follow-on work referred to above, I recommend that in addition to the changes in the definition of a money market fund that are referred to in Section 23.01 (and which I have recommended be implemented without delay), the CSA also add the following requirements to the criteria that must be met in order for an investment fund to be described as a money market fund:

(1) A requirement that all funds that are described as money market funds prominently note in all prospectus disclosure documents, marketing materials and in trade confirmations that the securities issued by the money market fund are not insured by CDIC and that there is no guarantee with respect to the amount of capital invested in the fund.

(2) A requirement that all funds that are described as money market funds be required to treat all portfolio transactions for the money market fund as being on income account.

(3) A restriction that provides that all funds that are described as money market funds may not use derivatives.

(4) A requirement that all funds that are described as money market funds be required to mark their investment portfolios to market at least on a weekly basis or immediately if the Bank of Canada rate moves by more than 1/2 of 1 per cent.

(5) If the market value of a fund that is described as a money market fund deviates from the stated amortized cost (i.e. from the \$1 or \$10 constant net asset value), by more than 1/10th of 1 per cent, a requirement that: (i) the investment portfolio be marked-to-market daily until such time as the deviation has been reduced to, and remains at, less than 1/10th of 1 per cent for a period of one week, and (ii) a requirement that corrective action be required to be taken if, and as long as, the deviation of market value to amortized cost is 3/10ths of 1 per cent or higher.

The suggestion has been made that a requirement of this nature should apply to all investment funds.

(6) A restriction funds that are not money market funds may not offer their securities at a constant net asset value.

24. PERFORMANCE INFORMATION

One of the most controversial elements of the disclosure system as it relates to investment funds is the use - or misuse - of performance information. There are many concerns about how performance information is being calculated and how it is being used. The major concerns centre around the following:

Reliance on the Past to Predict the Future

Despite cautionary statements to the effect that past performance is not predictive of future performance, there is concern that investors are not heeding this warning and are being unduly influenced by performance numbers - particularly short term performance numbers - in making their investment decisions.

Emphasis on Short Term Performance Results

The concern is that the emphasis on short term performance numbers:

(i) tends to create the impression that a fixed rate of return is promised;

(ii) puts undue pressure on investment managers to perform in the short term, causing them to engage in a variety of practices to "juice up the returns" in order to retain investors and to attract new investors to their sponsored investment funds;

(iii) is inconsistent with the long-term investment objectives that investors have been advised that their investment funds aim to achieve;

(iv) encourages investors to switch funds in their search for performance which usually means that investors sell their "old funds" at a low point and buy their "new funds" at a high point;

(v) constrains the ability of the investment fund manager to fully manage the investment portfolio because of the need to maintain added liquidity to fund redemptions resulting from the pursuit by investors for performance.

Sufficiency of the Standards for Calculating Performance Information

There is concern that there are no generally accepted standards for calculating performance information for investment funds that are required to be adhered to. This concern exists despite the provisions of National Policy No. 39 regarding the calculation of standard performance data.

The reason for the perception that there are no generally accepted standards for calculating performance data is probably attributable to: (i) the fact that the provisions of National Policy No. 39 may not sufficiently address the requirements for the underlying calculations of standard performance data, and (ii) the provisions that are included may not be being complied with.

With respect to the sufficiency of the provisions of National Policy No. 39:

(i) Questions have been raised about how performance information can be comparable when there are no standard requirements (with certain exceptions contained in Section 14 of National Policy No. 39) for the valuation of the assets and of the liabilities of an investment fund, the recognition of income, expenses and capital transactions and for how the net asset value of an investment fund is to be calculated.

(ii) Concern has been expressed about the lack of uniformity with respect to several matters that affect how performance information is calculated. For example, questions have been raised about:

- the consistency in netting out all expenses and charges made to the investment fund;

- the appropriateness of comparing the performance of an investment fund that has benefitted from fee waivers or the assumption of expenses with investment funds that have not benefitted in this manner;

! the adequacy of the disclosure requirements with respect to fee waivers or expense assumptions;

! the lack of uniformity with respect to calculating the average amounts that are used as the basis of determining fees; for example, where an investment fund manager's fee is based on a percentage of the average net assets of an investment fund during the year, variations in how the amount of the average net assets of the investment fund during the year is determined will have an impact on the amount of the investment manager's annual fee, the expense ratio and performance information; a similar problem exists with respect to wrap accounts where the fees are based on assets held in the account; in addition as withdrawals from these accounts are not treated uniformly, this gives rise to questions about the comparability of the performance of wrap account with other products.

There is concern about the lack of comparability of: (i) product to product, (ii) year to year performance, and (iii) competitive product to competitive product.

(iii) Two questions have been brought to my attention with respect to investment funds that have multiple classes of securities:

! Does the performance data that is being quoted relate to the class of securities that the investor owns?

! How are income and expenses allocated in the case of multiple class funds? I have been told that there is no common standard and that the method of allocation may result in material differences in the net asset value.

These questions raise issues that need to be considered in a broader context than just that of the impact on "performance information". They raise issues about the sufficiency of disclosure and conformity with securities regulatory requirements.

Changes in Investment Objectives and Policies

Many investment funds have made fundamental changes in their investment objectives and policies. These investment funds in effect become new investment funds yet they continue to use performance information that predates the fundamental changes. The result of this is that the information becomes misleading because of the lack of comparability.

Changes in Portfolio Managers

Where changes have been made in the portfolio manager of an investment fund, whether those changes relate to changes in the internal personnel of the portfolio manager or to a change of the portfolio manager, there is concern that there is inadequate disclosure of the fact that there have been changes and that the track record of the prior personnel of the portfolio manager or of the prior portfolio manager, as the case may be, continues to be reflected.

Mergers of Investment Funds

Where investment funds are merged, the appropriateness of the use of performance information of the respective funds for periods prior to the merger has been questioned.

Lack of Monitoring of Performance Information

In addition to the concerns about the methodology used to calculate performance information, there is a concern that there is no requirement for independent verification as to whether information that purports to be calculated in a certain manner has, in fact, been calculated in such manner. People have expressed concern about the lack of monitoring of performance information about investment funds.

As well, there is no requirement for independent verification that an investment fund that is characterized as being a specific type of investment fund is in fact one. Examples given in this respect have referred to investment funds that are characterized as conservative bond funds whereas an analysis of their investment portfolios and trading shows that, in fact, they are investing in or using highly-leveraged derivative instruments which substantially change the characterized risk profile of the funds. In the case of one of these funds where a third party portfolio manager had been retained by the investment manager to manage the fund's investment portfolio, apparently the investment manager was not aware of this.

Problems of this nature are worrisome from a variety of perspectives including the adequacy of the expertise of the investment manager to perform its functions, the monitoring of the activities of portfolio managers, the representations made to the public and to the regulators about the nature and risk profile of the investment fund in addition to questions that such matters raise relating to the comparability of performance information and the potentially misleading nature of it.

Categorization of Investment Funds

People have observed that the investment fund categories that are in current use are too broad and there are not enough categories. They say that there is a need for sorting funds into appropriate categories for two reasons - (i) for ranking comparability and (ii) so that people will know what they are getting when they invest in a fund.

Currently, with the exception of the provisions contained in National Policy No. 39 relating to money market funds, no criteria have been prescribed as to the investment composite that must be met in order for an investment fund to be classified by its investment manager or by a third party as a particular type of investment fund.

I have been told that often the indicator used for categorizing investment funds is the name of the investment fund notwithstanding the fact that such name may bear no resemblance to the actual composition of the investment portfolio.

With respect to categorization standards, I have been told that there is a need to specify what criteria must be met throughout the period in question in order for an investment fund to be categorized, for example, as a bond fund or as an equity fund. Additionally, as there are different categories of bond funds and of equity funds, I have been told that there is a need to specify the criteria that must be met throughout the period in question in order for an investment fund to be included in any particular sub-category of an equity or a bond fund.

Another area where I understand that there currently seems to be insufficient categorization standards relates to sector funds. For example, in the case of geographic sector funds, people have pointed out that for comparability purposes, a Latin American investment fund, the investments of which are confined to equity securities of issuers that operate only in one country of South America, does not belong in the same category as a Latin American investment fund the investments of which are in a balanced portfolio of securities of issuers that operate in all of the countries of Central and South America.

Notwithstanding the observations made by some industry participants that the investment fund categories that are in current use are too broad and that there are not enough categories, there is concern by other industry participants that in the effort to remedy this, the result may be that legitimate investment decisions for a particular fund may be constrained by whether the implementation of the decision would result in the investment fund no longer meeting the composite requirements for the category. It would seem that there should be some middle ground that would establish parameters that would not be misleading to investors and would not unreasonably restrict a portfolio manager from managing the investment fund in accordance with its stated objectives and risk profile.

Benchmarks

I have been told that the use of benchmarks gives rise to a series of concerns including:

(i) the concern that the benchmark(s) to which an investment fund's performance is being compared may not be relevant to or comparable with the investment fund in question;

(ii) the lack of transparency in the case of certain proprietary indexes where limited disclosure is made as to the composition of the index and how performance is calculated;

(iii) the potential for abuse when the same firm that compiles a proprietary index (which is often used as a measure in valuing derivatives) also trades in the securities that are included in the index; in this respect, delays in publishing information can affect valuations and the transactions that are based thereon;

(iv) the methodology used by the owner, or parties related to the owner, of a proprietary index in comparing the performance of investment funds to a proprietary benchmark; in this respect, the question has been asked as to whether the same methodology for determining performance is used for all investment funds or is the deck stacked so that the sponsored investment funds or other managed account products keep coming up as the fund or product of choice to meet investors' needs; and

(v) the concern that comparing the performance of an investment fund to benchmarks is misleading by reason of the fact that the performance information given about the benchmarks does not reflect any sales or transaction charges or income tax payable by an investor and, in some cases, such as an index of life insurance segregated funds, the performance information is calculated before deduction of fees and charges.

Comparisons to Other Investment Vehicles

Where performance is being compared with other investment vehicles, there are no uniform standards and rules for measuring the performance of the investment fund and of the other investment vehicles. For example, in comparing the performance of an investment fund to a life insurance segregated fund, the performance information about the segregated fund is before the deduction of any expenses charged to these funds.

Investor's Cash Flow

The performance information given to investors does not correlate to the respective investors' cash flow and this causes confusion. There is concern that investors have not been given an indication of what the after-tax rates of return are for investments held by individuals who are investing outside a tax-deferred plan.

Changes in Measurement Periods

People are concerned about the flexibility that there is to change measurement periods because changes in measurement periods have a significant impact on performance information. In down markets, people are able to "smooth out the curve" by changing the period that they measure. This affects comparability of the information as well as its usefulness to investors as opposed to its usefulness to people who are marketing investment funds and other competitive products.

Misleading Information in and Presentation of Charts and Graphs

There are concerns about the use of charts and graphs that are misleading to investors.

Training for Sales Representatives

Concern has been expressed about the level of understanding that sales representatives have about performance information and how such information should or should not be used.

Use of Performance Information as a Measure of Risk

Performance information is increasingly being used on a forward-looking basis to measure portfolio risk. Concern has been expressed about the ability of sales representatives and of investors to understand the relevant risk-measurement concepts and to apply them meaningfully. In this respect, while people have acknowledged that it is possible to explain certain risk-measuring concepts in relatively simple terms, they have expressed concerns about how such information may be misinterpreted by people who do not have the requisite skills, knowledge and judgment to properly assess and use the information. For example, the use of the concept of "duration" as a risk measure can be explained in relatively simple terms but its usefulness for predicting how a bond fund will perform in the future involves more than just a simple mathematical calculation or correlation to changes in interest rates.

See *A Graphic Display of Muddled Thinking* by Ron Blunn (The Financial Post - October 22, 1994) for a discussion of a variety of practices that result in charts and graphs being misleading.

Currency Component

Concern has been expressed that although the impact of foreign currency transactions is often a significant component of performance information, there is no requirement to indicate this or disclose any currency overlay strategies.

Sufficiency of Administrative Capability to Calculate Performance Information

Questions have been raised about whether portfolio accounting systems have the ability to track and properly account for currency overlay strategies and for the derivative positions that are entered into in order to counter future moves in the currency of securities holdings.

In addition, a general concern has been expressed about whether investment managers have sufficient administrative capability (people, equipment and systems) to calculate performance information because of the specialized resources that are required.

Concern has also been expressed about the number and frequency of the demands made on investment managers to provide performance data and the strains that these demands place on the capacity of investment managers to provide the information.

Rankings and Ratings

Concern has been expressed about investor confusion over the difference between a ***ranking*** and a ***rating*** of investment funds and about the lack of investor understanding with respect to how investment funds are ***ranked*,** particularly having regard to the many questions about the comparability of the information indicated above. Even more concern has been expressed in this context about how investment funds are ***rated*** and the potential for rating information to be both misleading and misused. Accordingly, questions have been asked about whether it is appropriate for investment funds to be either ranked or rated.

In explaining the difference between a ranking process and a rating process, Lipper

Analytical Services, Incorporated ("Lipper") in an article dated May 16, 1994 entitled "Selling the Future - Concerns About the Misuse of Mutual Fund Ratings" defines "ranking" as being a non-judgmental mathematical process in which like funds are arrayed on the basis of their performance and "ratings" as being subjective evaluations of funds. Lipper goes on in the article to state that:

> "While ratings may employ a mathematical scoring system, the elements of the rating formula are the result of subjective decisions. A rating is the result of a judgmental process in which a decision has been made to emphasize some fund characteristics over others. In taking on the role of experts, rating organizations - with one notable exception - bear prospectus liability**.**
>
> Usually, ratings are used to indicate a relative judgment about quality that would be expected to persist over time**.** The result is that investors who buy funds with high ratings come to have explicit expectations that these portfolios will be winners. While producers of ratings disavow their use as predictors of investment performance, the ratings are nonetheless being promoted as forecasts of future fund behaviour. Persons who stand in a fiduciary relationship to fund buyers are putting forward ratings as a form of independent investment advice.
>
> Despite the widespread use of ratings in sales promotions, little evaluation has been carried out on their usefulness to investors. The positive investment climate of recent years has proved fertile ground for promoting ratings systems, while prompting little critical appraisal of their effectiveness."

Lipper identifies some questions that fund professionals should be asking about the use of ratings, namely: (i) Do ratings create unreasonable expectations? (ii) Do rating systems help investors avoid large losses? and (iii) Do ratings result in the purchase of funds that are inappropriate to the needs of investors?

In an attached case study to the article that analyzed the performance of five-star funds in recent years, Lipper's summary of its findings indicates that: (i) five-star funds tended to underperform in subsequent 12-month periods, (ii) five-star ratings did not help investors avoid double-digit losses in the last down year for equity funds, (iii) a five-star strategy has tended to put investors into the wrong funds at the wrong time, (iv) five-star funds are not statistically different performers than the average equity funds, and (v) five-star ratings have been unreliable for selecting fixed-income funds.

Lipper concluded its article by urging fund professionals to take a rigorous look at the fundamental issue of whether the use of ratings in sales efforts is in the long-term interest of investors.

Media Involvement in Performance Information

Concern has been expressed about the involvement of the media in the publication of performance information. In this respect, the concern relates to the frequency of the publication of this information and the emphasis that has been placed on short-term performance results, which emphasis is considered to have encouraged investors to have a short-term focus on their investments and to seek out the "flavour of the month" with all the attendant problems outlined above. On the other hand, people expressing these concerns have acknowledged that their concerns would be somewhat alleviated if there were to be common standards and requirements to which industry participants and the media adhered with respect to the calculation and use of performance information.

Performance Information - "Young Funds"

There is a lot of concern about the use of performance information about investment funds that have not had at least one year's operations. Currently, performance information about such funds is not permitted to be included in sales communications.
Some people have asked that this restriction on the use of performance data for "young funds" be removed on the basis that sales representatives and investors want the information, they are given it on an individual basis, and the information should be made available to everyone.

Other people are of the view that performance information about a fund that has less than a year's operations is not meaningful and is misleading. They say this is particularly so where the fund's actual investments during the period differ from what its investment objectives indicate its investments will be. A situation such as this frequently occurs in the start-up phase of a new investment fund.

Aging of the Performance Information

Some people expressed concern about the current requirements that performance data must be measured from a period that ends on a calendar month end that is not more than 45 days prior to the time when the information is first used.

Consistency of Performance Information

There is concern that there is no requirement that the same performance information be used consistently for all purposes so that what appears in sales communications is the same as what appears in annual, interim or other reports to investors and is given to the regulators and to the media.

24.01 Suggested Regulatory Strategy

With the adoption of the changes to National Policy No. 39, which became effective on August 1, 1992 and which permit the use of comparative performance information by investment funds, the use of performance information has become so pervasive throughout the industry that I believe the only practical regulatory strategy that the CSA can now adopt with respect to performance information is one that permits the continued use of such information but is aimed at better regulating the manner in which such information is calculated and how it may be used. This basic approach is currently reflected in many of the provisions contained in Section 16 of National Policy No. 39. However, despite the fact that Section 16 contains provisions aimed at dealing with some of the concerns noted above, it would seem, in light of the concerns that have been expressed by industry participants, that such provisions either are not being complied with or are not sufficient to deal with the issues raised.

Accordingly, I am suggesting focussing on better regulating the manner in which performance information is calculated and how it may be used. Such strategy should, in my opinion, be combined with a regulatory strategy that is aimed at de-emphasizing short-term performance as the sole criterion that investors focus on in selecting what investments to make.

I believe that the measures outlined in the previous sections of this report that are directed

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For example, Section 16.04 (viii) of National Policy No. 39 requires disclosure of changes in the management of an investment fund, changes in fundamental investment objectives, changes in any portfolio adviser, changes in ownership of the investment manager and changes in fees or charges, including the waiving or absorbing of fees or charges, that would have materially affected the investment fund's performance.

at improving the knowledge and awareness of investors, the training and proficiency of sales representatives and financial planners and the improvement of disclosure materials should facilitate this. Such measures should also provide investors with a means to focus on where an investment fund is going and how it intends to get there by enabling investors to understand and evaluate the investment objectives of an investment fund, its investment management style, its historical volatility, its risk profile and the integrity and experience of its management. It is important that the disclosure materials make this information abundantly clear so that investors are able to consider whether their own personal goals and their tolerance for loss are matched by the investment objectives of the investment fund, its risk profile, its investment experience as reflected by its performance history, its investment management style and the integrity of its management.

In addition, there is a need for a more pro-active approach to be taken with respect to compliance with the provisions contained in Section 16 of National Policy No. 39. These provisions are designed to prevent misleading advertising and inappropriate sales practices. The failure to monitor compliance with these provisions and to take appropriate action has contributed to the development and to the continuation of unsatisfactory practices. If serious consequences were to flow from the use of misleading performance information, this would be a major deterrent to its use.

Recommendations

It is therefore my recommendation that:

(1) The requirements with respect to performance information be reviewed in light of the experience gained in the last two years. In this respect, the rapid developments in technology, modern portfolio theory, portfolio analytics and risk management techniques, combined with the development and adoption by professional associations such as the Association of Investment Management and Research ("AIMR"), of recognized standards for calculating performance information should make this complex task somewhat easier. The heightened awareness of the underlying issues by a greater number of people should also assist in completing

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Reference is also made to Section 25.03 for a suggested alternative approach to portfolio management based on "portfolio risk/prudent man principles" and the suggestions respecting relevant disclosure.

this task.

(2) A pro-active approach be taken by the Competition Tribunal and by the CSA, the existing self-regulatory organizations, IFIC and the SRO to deal with misleading advertising and other sales communications. It is important that this action be taken in a timely manner as once misleading information is disseminated the damage occurs. It is my recommendation that the primary effort in this respect be taken by the CSA, the existing self-regulatory organizations, IFIC and the SRO (as the case may be). In conjunction with this effort, consideration should be given to including requirements for pre-clearance of advertising that contains performance information.

24.02 Rules Respecting the Calculation and Use of Performance Information

As part of the follow-on work arising out of this report, I recommend that a working group or project team be formed to develop a proposal for uniform rules respecting the calculation and use of performance information that will ultimately be required to be universally used by all industry participants with respect to performance information that such industry participants may choose to give to or in respect of all types of managed accounts. Consideration should be given to whether it is possible to develop international standards in this respect.

Because so many aspects of this matter relate to the proposed responsibilities of the SRO with respect to its rules relating to fair practice and business conduct (including advertising), it is my recommendation that the work of this working group or project team should be part of, or coordinated with, the work that results in the establishment of the SRO and the adoption of its rules. However, because of the specialized knowledge that is required in order to identify and articulate the underlying requirements for the standards that are required to be met with respect to the calculation and use of performance information, I suggest that initially a relatively small number of people with the requisite expertise be asked to work on the more technical aspects of this matter. This effort should commence immediately and not await the implementation of the proposals for the SRO.

Once the SRO is established and the Securities Regulator is satisfied with the SRO's rules relating to advertising, fair conduct and business practices, it is my recommendation that the role of the Securities Regulator should be confined to exercising general regulatory oversight with respect to these matters and that the SRO should assume responsibility for monitoring compliance with the rules relating to the calculation and use of performance information.

24.03 Recommendations for the Conceptual Framework

My specific recommendations with respect to establishing the conceptual framework for the requirements relating to the calculation and use of performance information are set out below.

Universal Common Standards

I recommend that the conceptual framework reflect the need to identify, articulate and require adherence to a ***uniform*** *or* ***common*** set of standards that would be ***universally*** used. These standards are hereinafter referred to as "universal common standards".

Once the universal common standards are identified, if these standards are the same as those of another organization, the standards of such other organization(s) could be recognized as complying with the universal common standards.

In this respect, many people have suggested the possibility of simply adopting the AIMR Performance Preparation Standards for this purpose together with a requirement to adhere to the AIMR Code of Ethics and Standards of Professional Conduct. It was suggested that as chartered financial analysts are bound by the AIMR Standards and Code, there is presently wide adherence to the same and this would be a simple means of arriving at universal common standards. The reservations that were expressed about the possibility of adopting the AIMR Standards and Code related to questions about whether the AIMR Performance Preparation Standards were broad enough to deal with all of the issues related to investment funds. It was suggested that the present AIMR Standards are more appropriate for measuring the performance of investment fund managers.

I understand that AIMR is currently developing additional standards to deal with issues that relate to investment funds.

Other people noted that while it was desirable that there be a set of standards that are uniformly adhered to, it was not desirable to recognize the standards of only one organization.

I am concerned that if the standards of several organizations were to be recognized without there being a requirement for conformity with the universal common standards, many of the same concerns that are outlined in the introduction to Section 24 would continue to exist.

The recommendation that I have made for universal common standards addresses both the need for such standards and the possibility that there may be several organizations whose standards conform with the universal common standards.

I would expect that in developing the universal common standards, that it will be possible to draw heavily on the work done by the various regulatory and other organizations that are involved in this field including the SEC, the United Kingdom's Investment Management Regulatory Organization (which is known as "IMRO") and AIMR.

It is important to recognize that as in the case of the debate on how to calculate the yield of a money market fund, there will be many issues as to which there will be no absolutely right or wrong answer. It will be essential not to become enmeshed in academic debates that from the investor's point of view are akin to how many angels can be on the head of a pin. In resolving these issues, I recommend that because performance information is aimed at investors, the persons charged with identifying and articulating the universal common standards look at the underlying issues from the perspective of what is the "best practice" from the investor's point of view. This may well require a weighing of factors. If there should be more than one "best practice", I suggest that a choice simply be made as to the "best practice" to adopt. While this suggestion may be considered to be somewhat arbitrary, it should be kept in mind that the purpose of the exercise is to identify and articulate ***common and uniform standards of universal application.*** Accordingly, as long as everyone is applying the same universal common standards the information that is produced should be comparable.

In addition, in order to address the need for comparability, I contemplate that the universal common standards that are developed will need to be much more detailed than the current provisions relating to "standard performance data" that are contained in National Policy No. 39. I also contemplate that in order to achieve comparability, there will likely be a need to allow less flexibility with respect to choosing the commencement date of the time periods that are measured.

In order to achieve comparability, I believe that it will be necessary to develop uniform rules with respect to how net asset value is determined, including uniform rules with respect to the valuation of assets and liabilities, the recognition of income, expenses and capital transactions, the calculation of average amounts and the calculation of the net asset value. Some people have suggested that securities regulators should not be involved in these areas as they should be governed by generally accepted accounting principles of the CICA. However, in discussing this suggestion, it was pointed out that generally accepted accounting principles are only intended to address the **basis** for accounting - i.e. the underlying principles that are to be applied - and are not intended to deal with the **methodology** for how values are arrived at. Accordingly, if there are to be uniform rules with respect to how net asset value is to be determined, including uniform rules with respect to the valuation of assets and liabilities, the recognition of income, expenses and capital transactions, the calculation of average amounts and the calculation of net asset value, neither the regulators nor the industry should expect the CICA to articulate these rules as part of what is considered to be generally accepted accounting principles or standards. The regulators and the industry need to take the initiative in developing these uniform rules and in developing a mechanism that will allow for additional rules and changes to existing rules to be made on a timely basis to address the needs of the changing marketplace.

There is also a need to develop universal standards for how investment funds are to be categorized. These standards would presumably address the issue of variances that occur during the period in the composition of the investment portfolio from the standards required to be met in order to be categorized as a particular type of investment fund and would restrict the use of data in that category for non-conforming periods. The result of this recommendation may well be that some funds will be considered to be "young funds" in respect of the use of comparative performance information or will be required to include additional performance information respecting the performance in their actual category (as opposed to their stated category) with an indication of their ranking in comparison with the other investment funds in the actual category. These same comments apply to situations where there have been fundamental changes in the investment objectives and policies of an investment fund, changes in the portfolio manager of an investment fund and mergers of investment funds.

In developing these standards, care needs to be taken to address the need referred to under the heading "Categorization of Investment Funds" to avoid setting too rigid standards that would result in legitimate investment decisions for a fund being constrained by concerns for continuing category eligibility. In the case of investment funds whose past performance has been poor, care needs to be taken that a change in the category of an investment fund or a change in investment objectives of an investment fund or a change of the portfolio manager of an investment fund will not become a means of eliminating the need to disclose poor past performance by eliminating the requirement to reflect the historical information concerning the investment fund.

Verification of Compliance with the Universal Common Standards

There is a need to provide for verification that the performance information has been prepared in accordance with the universal common standards. Such verification should include some external confirmation in this respect. I am told that this can be done as part of an auditor's derivative report on matters arising from an audit without adding significant costs. The performance information together with the auditor's verification of it should be included in the annual and interim reports of an investment fund. The question of whether this material should form part of the financial statements or form part of the MD&A or should be a separate item included with the financial statements is one that I suggest be addressed as part of the follow-on work arising from this report.

Universal Use of the Universal Common Standards

There is a need to provide for universal use of the universal common standards by all industry participants regardless of what their particular function is and to enlist the cooperation of the media in ensuring that the performance information used by the media is calculated and used in accordance with the universal common standards.

24.04 Benchmarks

Where an index is created that is intended to be used by others as a measure of performance or for valuation purposes, there should be a requirement that there be public disclosure of what the index consists of and how the information that is contained in the index is compiled. If there is any change in this information, such change should be required to be disclosed publicly. In this respect, the disclosure should result in there being complete transparency so that the performance results of the index can be independently verified using published data. This is particularly important where the index is used as a measure in valuing derivatives and the firm that "owns" the index is also trading in the securities that are comprised in the index.

24.05 Education of Sales Representatives and Investors

There is a need to ensure that the training of sales representatives includes an understanding about how performance information is calculated and how it should be properly used to assist investors with their investment decisions. This is particularly so in the case where performance information is used either as a rating measure or as a measure of risk. Similarly, there is a need to assist investors in understanding these matters through providing basic information about the use of performance information in the generic education document and specific information in the annual and interim reports as well as in any other means used to inform investors.

Hopefully, a better understanding of these matters by all persons involved in investment decisions will alleviate some of the concerns arising about the use of performance information and, in particular, concerns about the emphasis on short term performance results and the tendency to perceive past performance as indicative of future performance.

24.06 Rules of Fair Practice

The rules of the SRO respecting advertising, fair practice and business conduct should address the various questionable practices that are reflected in the concerns set out in the introduction to Section 24. I recommend that these SRO rules should include provisions that require:

(1) disclosure of the methodology that has been used to calculate performance information, the requirement to apply such methodology on a consistent basis, the requirement to disclose any changes that have been made in such methodology, the reason for and impact of the change, and, if appropriate, the requirement to restate figures to give effect to the changes throughout the periods covered by the performance information;

(2) the use of the same performance information for the same periods in all advertising materials, prospectus disclosure documents, annual and interim reports to securityholders and other sales communications;

(3) disclosure of changes in the portfolio manager of an investment fund, whether those changes relate to changes of key internal personnel responsible for managing the investment portfolio or to the change of the portfolio manager, with a requirement to show separately: (i) the performance record following such change as if the investment fund had commenced operations on the effective date of the change, and (ii) the historical performance record for the period of the fund's existence, provided that the maximum period required to be shown would be the lesser of ten years or the life of the investment fund;

(4) where investment funds have been merged, disclosure of this fact and, if such merger is combined with a change in the portfolio manager (as outlined in clause (3)) or a fundamental change in the investment objectives and policies of the fund (as outlined in clause (5)), a requirement to show separately: (i) the performance record of the merged fund as if the investment fund had commenced operations on the effective date of the change, and (ii) the historical performance record for the period of the funds' existence, provided that the maximum period required to be shown would be the lesser of ten years or the life of the investment funds;

(5) disclosure of fundamental changes in the investment objectives and policies of an investment fund with a requirement to show separately: (i) the performance record following such changes as if the investment fund had commenced operations on the effective date of the change, and (ii) the historical performance record for the period of the fund's existence, with the maximum period required to be shown to be the

lesser of ten years or the life of the investment fund;

(6) that the name of an investment fund not be misleading in respect of the identification of the type of securities held in its investment portfolio;

(7) where an investment fund has multiple classes of securities, the performance information that is given to be given separately for each class of securities;

(8) that charts and graphs not be inherently misleading; this may require an articulation of practices that are considered to be inherently misleading such as: (i) the "backward time line ruse", (ii) the "non-zero base line trick", (iii) the "disappearing quantity perception", (iv) the "mismatched scales illusion", and (v) the "missing year hoax";

(9) the same periods of time to be used in calculating performance information about investment funds, other managed accounts and indexes so that the information being compared relates to the same time period;

(10) that the after-tax rates of return be given for investments held by individuals who hold their investments outside a tax-deferred plan; this will require the use of a hypothetical example or examples based on stated assumptions;

(11) with respect to "young funds", disclosure to be made that the investment fund has not been operating for a full year, together with a requirement to disclose the date on which operations commenced and a requirement that investment funds that have not been operating for a full year may not be included in any ranking or rating of investment funds unless throughout the period measured, their investments have conformed with the criteria for the category in question;

(12) that where a compound rate of return is given for a period that is longer than one year, the uncompounded annual rate of return for each of the years in the compounded period also be shown;

(13) the illustration of percentage changes in terms of dollar amounts as well as

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See *A Graphic Display of Muddled Thinking* by Ron Blunn (The Financial Post - October 22, 1994).

percentages.

The foregoing is not intended to be an exhaustive list of "fair practices" but merely to give an indication of recommendations that might address the concerns that have been raised about the use of performance information which are outlined above.

24.07 Rankings and Ratings

Subject to developing universal common standards with respect to how performance information is calculated, there does not appear to be any reason for there to be regulatory restrictions on the numerical ranking of investment funds based on this information. However, the practice of rating investment funds needs to be carefully considered because of the potential such ratings have for misleading investors. I am not convinced that a means exists for avoiding this result. There is also a concern about the vulnerability of industry participants to legal actions based on misrepresentations respecting the use made by them of these ratings and the potential adverse effect that this might have.

I think it would be desirable for the matter of whether there should be any restrictions or prohibitions on the use of ratings to be considered by the working group or project team referred to in Section 24.02, both from the perspective of the development of the universal common standards and the development of the SRO's rules with respect to advertising, fair practice and business conduct.

24.08 Other Aspects Regarding the Use of Performance Information

The adoption of universal common standards and of binding rules with respect to advertising, fair practice and business conduct relating to the calculation and use of performance information combined with improved education and training of sales representatives, measures aimed at improving investors' understanding and awareness of these matters and the enhanced disclosure provisions discussed in this report, should alleviate many of the concerns that have been expressed about the use of performance information as a measure of risk on a forward-looking basis. I therefore see no reason not to encourage industry participants to use this information responsibly.

It will be important for the Securities Regulator to monitor what is happening in this area with a view to taking or causing appropriate action to be taken if there is a need to do so. With respect to the concerns that have been raised about the sufficiency of administrative capability (people, equipment and systems) with respect to the requirements relating to the calculation of performance information, these concerns should be addressed by the recommendations made in Sections 14.01 and 25.03 .

25. INVESTMENT OBJECTIVES, POLICIES AND RESTRICTIONS - NATIONAL POLICY NO. 39

During the course of my review, several changes were suggested with respect to the present provisions of National Policy No. 39 and the corresponding provisions of National Policy No. 36 relating to investment objectives, policies and restrictions. These are discussed below.

25.01 Better Disclosure of Investment Objectives and Policies

There is virtual unanimity about the need to provide for better disclosure of what the fundamental investment objectives and policies of an investment fund are and how it is intended to achieve these objectives. Where derivatives are used, there is general agreement that there is a need that there be a better explanation of how derivatives will be used to accomplish the stated fundamental investment objectives and policies of the investment fund. Whether or not derivatives are used, there is general agreement that there is a need to outline the intended risk profile of the investment fund in conjunction with the explanation of the fundamental investment objectives and policies of the investment fund. Several people recommended that information based upon the investment fund's actual performance, with a discussion of the significant factors contributing to it both historically and prospectively, needs to be included. Virtually everyone agreed that the information that is given needs to be simple and jargon-free so that an investor can readily determine whether investing in the fund is compatible with the investor's personal goals

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This is an area where it may be desirable to seek to standardize some of the descriptions of the investment objectives and policies of an investment fund. I suggest that this matter be reviewed as part of the follow-on work resulting from this report. In this respect, I think that it could be an ancillary matter to the work of the working group or project team referred to in Section 24.02 in connection with the development of a proposal for uniform rules respecting the calculation and use of performance information.

and tolerance for loss. I am in complete agreement that these are real needs and the recommendations contained in this report are directed towards enabling the CSA to take the appropriate action to meet such needs. In particular, the recommendations contained in Section 17 with respect to the disclosure system and the recommendations contained in Section 24 with respect to the calculation and use of performance information should assist in this respect.

25.02 Changes in Fundamental Investment Objectives and Policies

Where the fundamental investment objectives and policies of an investment fund are changed, it is important that this change be clearly brought to the attention of investors, including existing securityholders. The fact that existing securityholders may have received notice of a meeting of securityholders to authorize the changes is not, in my opinion, sufficient emphasis of the fact that the nature of the investment held by them has fundamentally changed or may do so. Something more than just complying with the legal requirements respecting obtaining securityholder authorization for fundamental changes is needed to highlight this fact. The recommendations that I have made in Section 17.04 (regarding MD&A and material change reports) and in Section 24 (regarding performance information) should address the need in this respect.

25.03 Investment Restrictions and Practices - A Suggested Alternative

A suggestion was made that if portfolio risk were required to be appropriately quantified and emphasized in the marketing and distribution of investment funds, portfolio managers could concentrate on managing the risk of the investment portfolio as a whole instead of concentrating on the risk inherent in each of the individual instruments contained in the investment portfolio and that this is the more appropriate focus for portfolio managers.

Reference is made to Sections 17.03 and 17.04 for an indication of the type of information that is relevant in this respect.

I am told that modern portfolio theory demonstrates that the risk of a portfolio ***does not equal*** the sum of the risk of the individual securities and that it follows from this that any individual financial instrument might ***add risk*** to one portfolio and ***reduce the risk*** of another portfolio. Therefore, regulation should concentrate on the ***portfolio risk*** and not the risk of individual securities. It was suggested that regulators may be defeating the purpose of controlling risk if the focus is on the individual instruments that comprise the portfolio and that allowing or disallowing specific instruments in portfolios may not, in fact, control risk

Accordingly, it was suggested that the investment restrictions and practices contained in National Policy No. 39 which allow or disallow certain investments could be eliminated and that such a shift in regulation would be consistent with the "prudent person" approach that is reflected in legislation relating to investments by certain pension funds and financial institutions.

The suggestion contemplates that issues related to restricting leverage would be dealt with by risk monitoring mechanisms designed to ensure that the overall portfolio risk was kept within the parameters specified in the investment fund's disclosure documents. Such an approach would deal not only with the leverage implicit in instruments such as futures but would also deal with the leverage implicit in portfolio instruments such as zero coupon bonds, warrants and high beta stocks which is not addressed in the present investment restrictions and practices contained in National Policy No. 39.

It is suggested that issues related to ensuring sufficient liquidity to enable an investment fund to meet its obligations to fund redemptions on demand would be dealt with by requiring the investment fund to maintain a certain percentage of its assets in investments that may be liquidated within a certain time frame. Liquidity estimates would be required to be made for each investment. Portfolio guidelines for liquidity would need to be prescribed. The proposal contemplates that a master list of liquidity for types of instruments would be devised.

Competency requirements for portfolio managers (including sub-advisers) would also need

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but may actually result in increased risk. Accordingly, it was submitted that the focus of regulation should move from ***instrument risk*** to ***portfolio risk.***

It was submitted that eliminating the investment restrictions and practices contained in National Policy No. 39 would facilitate the integration of securities and commodities activities and the consolidation of the Securities Acts and Commodity Futures Acts.

For illustrative purposes, the following guidelines were proposed:

1 day	-	05 %
5 days	-	25 %
15 days	-	50 %
30 days	-	90 %

to be aligned with the portfolio risk/prudent person approach. Suggested changes that might be made in this respect include: (i) requiring there to be at least two certified risk management professionals employed by each investment fund manager, (ii) requiring such persons to have successfully completed a risk management course designed to provide them with the ability to use modern techniques to measure portfolio risk, and (iii) requiring all portfolio managers using contingent claims (options, swaps, warrants, options on futures, protected equity notes and debt-like instruments) successfully to complete a course on the valuation of contingent claims.

The suggested guidelines for appropriately quantifying and emphasizing portfolio risk in the marketing and distribution of investment funds include: (i) a statement of policy that sets out the investment fund's objectives in terms of risk and return and identifies the type of instruments that the fund is allowed to invest in, (ii) providing risk parameter estimates in the investment fund's disclosure documents, (iii) providing a standard deviation number when reporting return figures, (iv) showing historical return numbers on the basis of individual years to demonstrate not only long-run returns but also the distribution of those returns, (v) providing the Sharpe Ratio in all marketing and reporting materials related to a given fund and displaying the ratio at least as prominently as any other measures including returns, (vi) making other measures such as the single largest one month drawdown (i.e. redemptions) available in the marketing and reporting materials, (vii) providing special notices to securityholders whenever actual risk measures exceed estimated risk measures, (viii) restricting claims that the estimated future risk will be less than the actual historical levels of risk experienced by the investment fund, and (ix) maintaining a corporate composite return in AIMR form and making this information available to all new investors or clients.

The suggested internal management practices that would be required if the portfolio

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There are a variety of risk measures that might be used including "standard deviation", the "Sharpe Ratio", the "beta", the "delta", the "gamma", the "theta" and the "vega" which are the measures referred to in this Section. 25.03. Appendix B of the AIMR Performance Presentation Standards describes: (i) the "standard deviation" of portfolio performance over time as being a measure of volatility that indicates how far data are spread about their central tendency or mean; (ii) the "beta" as being the average performance volatility relative to the market; and (iii) the "Sharpe Ratio" as being a measure of reward relative to total volatility that may be used to assist an investor to determine how much risk will maximize the investor's utility. "Deltas", "gammas", "thetas" and "vegas" are all measures of rates of change.

risk/prudent person approach were to be adopted include: (i) adherence to the disclosed statement of policy that sets out the investment fund's objectives in terms of risk and return and identifies the type of instruments in which the fund is allowed to invest, (ii) a requirement that the investment portfolio (including that of a money market fund) be marked-to-market on a daily basis according to prescribed methods, (iii) internal monitoring of the investment portfolio that includes sufficiently detailed attribution analysis to ensure that the portfolio manager understands the source of variation in fund returns, (iv) the portfolio manager being provided with the internal or external capability to measure, at least daily, the delta, gamma, theta and vega of the investment portfolio, (v) the capability of monitoring the change in the investment portfolio relative to a 1% change in rates, (vi) the portfolio manager being required to measure both current and potential credit exposure to individuals, corporate groups, industries and countries of origin, taking into consideration any enforceable netting available, (vii) investment management organizations able to ensure that the investment and the risk monitoring functions are independent, and (viii) investment management organizations being required to ensure that both the investment and the risk monitoring staff are adequately trained in the instruments being included in their portfolios. These provisions are reflective of those outlined in the Group of Thirty Global Derivatives Study Group Report, *Derivatives: Practices and Principles.*

It was suggested that a number of significant benefits would flow from adopting a portfolio risk/prudent person approach to regulation including:

Simplified Regulation	The process of developing regulations and managing compliance with the regulations would be simplified because the CSA would be relieved of the current need that there is for specificity in quantitative legislation.
Market Free to Develop New Instruments	Productivity could be enhanced in the financial sector because current

Derivatives: Practices and Principles, Global Derivatives Study Group, Group of Thirty, Washington, DC, July 1993 impediments to the use of new instruments would be removed. As new instruments are developed, regulations would remain stable and with very few exceptions, unchanged.

Regulators Free from "Catch-up"

Regulators are often behind the market in regulating new instruments. Focussing on overall risk instead of on a constant stream of individual security investments not only would free regulators from this frustration but would also facilitate their effectiveness by focussing energies on portfolios rather than the specific instruments.

Integration

The CSA would be able to integrate the regulation of securities and futures. The expertise that has been developed on the futures side could be effectively applied on the securities side as many of the derivatives are securities as opposed to commodities. In addition, the mathematics developed by the derivatives community over the last 20 years forms much of the basis for the proposed regulation of risk.

Increased Competition

Competition in the Canadian financial markets would be increased by giving end users more alternative investments. Portfolio managers would be free to include a wider range of instruments in their portfolios, thereby allowing greater diversity of fund profiles and closer matching of funds to fund purchaser needs.

It was submitted that given the CSA's current challenges in attempting to regulate portfolio diversification and liquidity amid accelerating changes in retail markets, the potential advantages of a shift away from restricting instruments towards designing guidelines for portfolio offerings based on a portfolio risk/prudent person rule approach appear to be worthy of the effort required to work through the implications of such a shift.

The reason I have outlined this proposal for a new regulatory approach in some detail is because I believe that there is merit in giving serious consideration to the proposal. The recommendations that I have made in Sections 25.01 and 25.02 are consistent with the suggestions outlined above for a portfolio risk/prudent person approach to portfolio management as are the recommendations made in Section 25.05 with respect to the use of derivatives by investment funds.

Many of the other suggestions reflected in the proposal make good sense as matters of good internal management practices and no regulatory action is required in order for investment management organizations to implement such practices. In fact, I think that many investors would simply assume that a professional money manager would have the type of capabilities and systems in place that are referred to in the proposal.

The recommendations contained in Section 14 are aimed at ensuring that these expectations are met. In addition, the recommendations made with respect to developing universal common standards for the calculation and use of performance information have been made with the objective of there being better information on which to base portfolio risk assessments. The recommendations in this report with respect to education, proficiency and disclosure are all aimed at making the information both comprehensive and readily available to assist investors in determining whether a particular investment is consistent with their own personal goals and tolerance for loss.

One issue that needs to be focussed on in the above proposal is whether in conjunction with the portfolio risk/prudent person approach outlined above, there is any need to require portfolio managers also to manage investment fund portfolios in accordance with the restrictions on investments and investment practices that are contained in National Policy No. 39.

Although I am not going to attempt in this report to answer, or to suggest an answer to, this question, I do have some concerns about the apparent underlying assumption that the adoption of a portfolio risk/prudent person approach necessarily means that all restrictions on investments and investment practices should be eliminated. I note that it is not unusual for "prudent person legislation" also to contain some overall limitations. I would be reluctant to see the elimination of the current restrictions on investments and investment practices without careful consideration being given as to why the restrictions were originally adopted and whether they still are needed to serve such purpose.

I also have concerns about whether the proposals concerning leverage and liquidity reflected in the above proposal are sufficient to address these matters without also including some of the current investment restrictions and practices that are aimed at the these matters. On the other hand, the proposals clearly raise questions about the sufficiency of the current provisions relating to leverage and liquidity that are contained in National Policy No. 39.

There are also questions about how compliance with stated investment objectives and practices could be meaningfully monitored if the only measure is the subjective "prudent person" measure.

Recommendation

I therefore recommend that part of the follow-on work arising out of this report include further study of this matter. I note that in the meantime, there is nothing that would prevent the establishment of an open-end investment fund that was proposed to be managed in accordance with the proposals outlined above, provided that the approval of the CSA was obtained to the investments not being limited by the investment restrictions and practices contained in National Policy No. 39. From a policy perspective, I do not see any reason why the CSA should withhold its approval if such a request were made, provided that the safeguards reflected in the suggested internal management practices outlined above are met, there is clear disclosure to the public that the investment fund is not a "conventional mutual fund" and the marketing and distribution efforts emphasize this. If there were to be open-end investment funds of this nature, they might over a period of time provide some empirical evidence as to whether the suggested alternative approach works well and should become the "standard approach" for open-end investment funds. To proceed in this manner would be a recognition of the reality that there is more than one way to manage liquidity and exposure to the chance of loss.

25.04 Investment Restrictions and Practices - The Existing Regime

Leaving aside the issues relating to fund of funds investments (which are discussed in Section 22), most people are comfortable with the existing provisions contained in National Policy No. 39 concerning the restrictions on investments and practices. However, there were suggestions that some changes of a fine-tuning nature should be made. These relate primarily to relaxing the percentage limitations on the maximum amount of the net assets of an investment fund that can be invested in a single issuer and the maximum percentage of any class, or series of a class, of securities that may be acquired by an investment fund. It has been suggested that exceptions should be made to the investment restrictions to permit investments in Toronto 35 Index Participation Units, Toronto 100 Index Participation Units and debt obligations of or guaranteed by foreign governments in excess of the current percentage limitations. I believe that all of these matters (with the possible exception of a suggestion to change Section 2.04(2)(b) of National Policy No. 39 to remove the series limitation in the case of debt obligations of a class that rank equally with each other) are before the CSA for consideration. I have not reviewed these suggestions in sufficient depth to make a recommendation to the CSA about whether the suggested changes should be adopted. I recommend that these matters be reviewed as part of the follow-on work resulting from this report.

25.05 Derivatives

Many people have expressed concerns about the use of derivatives by investment funds. From the point of view of disclosure, there is concern that the risk profile of an investment fund that is investing in derivatives may change significantly from what investors believe it to be. Examples given in this respect are referred to in Section 24.

I understand that comparable portfolio risk/prudent person approaches to the one outlined in this Section have been adopted by some closed-end investment funds and limited partnership investment funds that are offered for sale.

There is concern about the lack of monitoring measures to ensure that an investment fund that is investing in derivatives is conforming with the requirements of National Policy No. 39 respecting such investments. Subject to certain exceptions, National Policy No. 39 permits investment funds that are subject to this Policy to use "permitted derivatives" for hedging purposes only or, in other words, to enter into derivative transactions within a prescribed range to offset or reduce risk associated with all or a portion of the existing investments or group of investments of an investment fund. In addition, there is a concern that the provisions of National Policy No. 39 have not been tested as to their adequacy by market experience and that most investment fund organizations do not have the capital to make good their mistakes if experience should show that they did not understand the risk posed to the investment portfolio by the derivative positions or if synthetically structured securities do not perform according to expectations. Many people have suggested that investors who want to use derivatives as part of their investment strategy should do so outside a conventional "plain vanilla" investment fund.

Other areas of concern that were raised in connection with the present provisions of National Policy No. 39 with respect to derivatives relate to: (i) the fact that the provisions do not provide for an adequate mechanism for dealing with new products, (ii) the inability to use "synthetic cash" as collateral for long futures contracts, (iii) the cross-hedging requirements with respect to foreign currency risk, (iv) the fact that swaps are not included in the definition of "permitted derivatives" despite the fact that there is no restriction on entering into the component parts of a swap transaction, and (v) the fact that refinements are needed to deal with options.

A further concern relates to the fact that notwithstanding the provisions of Section 14.05 of National Policy No. 39, there are virtually no standards with respect to how derivative positions are to be valued. There is little help derived from the application of "generally accepted accounting principles" because, in effect, these principles simply require that the positions be marked-to-market. The unanswered question is: "What is the market value?".

See National Policy No. 39 - Section 1.01 for relevant definitions, Sections 2.04(1)(i) and 207 for investment restrictions on the use of permitted derivatives, Section 14.05 for valuation requirements respecting permitted derivatives and Section 14.06 for information about permitted derivatives that is required to be included in the Statement of Investment Portfolio.

I have also been told that settlement procedures relating to some derivative transactions are a concern.

Concerns were also expressed about the sufficiency of the expertise of the portfolio managers and of the investment fund managers (who are responsible for overseeing the activities of the portfolio managers) with respect to the nature and use of derivative positions and instruments, the depth of their understanding about the same, the sufficiency of the administrative capabilities of the portfolio managers and of the investment fund managers in terms of systems, personnel and equipment necessary to keep track of, account for, monitor and value derivative positions. There is also concern that the performance of many of the structured instruments in varying market conditions is untested.

In contrast to the concerns noted above is the attitude expressed by the Global Derivatives Study Group of the Group of Thirty that "derivatives by their nature do not introduce risks of a fundamentally different kind or of a greater scale than those already present in the financial markets". Paul Volcker, the Chairman of the Group of Thirty in making this statement observed that "...systemic risks are not appreciably aggravated, and supervisory concerns can be addressed within the present regulatory structures and approaches". In the Introduction to the Global Derivatives Study Group Report, it is stated at page 1 that:

> "Derivatives have fundamentally changed financial management by providing new tools to manage risk". ...
>
> "What makes derivatives important is not so much the size of the activity as the role it plays in fostering new ways to understand, measure, and manage financial risk. Through derivatives, the complex risks that are bound together in traditional instruments can be teased apart and managed independently, and often more efficiently". ...
>
> "Derivatives help to manage risk in new ways - an important economic function. Yet the risks involved in derivative activities are neither new nor unique. They are the same kinds of risks found in traditional financial

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Supra, note 126, Foreword, page i.

Supra, note 126.

products: market, credit, legal and operational risks".

The fundamental question is whether the concerns noted above are reconcilable with the perspective of the Group of Thirty Study and, if so, how. I think that the answer to this question is that they are reconcilable but some work will be required to be done in order to do this.

Recommendations

It is my recommendation that the CSA approach the matter of the continued use of derivatives by investment funds from the perspective that their use ***should*** be permitted as a means to manage market, credit, legal and operational risks with respect to the investment portfolio of an investment fund. In this respect, the proposal outlined in Section 25.03 was designed for this purpose and addresses many of the concerns that have been raised about the sufficiency of the expertise, understanding, systems, procedures and personnel of industry participants. The proposal also focuses on providing for timely and meaningful disclosure on a continuing basis to investors. As noted above, this should be an achievable goal if the recommendations made in this report are implemented concerning the disclosure system, proficiency requirements, standards with respect to the development and use of performance information, education and training of industry personnel and enhancing the ability of investors to understand and assess whether an investment in a particular investment fund is compatible with their respective personal goals and tolerance for loss.

In addition, there is a need to develop objective, commonly accepted standards for valuing derivatives and derivative positions. It is essential that this work be done without delay if derivatives are going to be permitted to continue to be used by or form part of the investment portfolio of an investment fund, the securities of which are redeemable on demand. The reason that I make this statement is that the integrity of the valuation provisions and procedures and the consistent application thereof is the cornerstone on which such open-end investment funds are founded. If it is not possible to develop objective, commonly accepted standards for valuing derivatives and derivative positions, then I question whether they should be used by or form part of a portfolio of an investment fund, the securities of which are redeemable on demand.

Similarly, there is a need for the CSA to be satisfied that an investment fund that is using derivatives to achieve its investment objectives has available to it the requisite investment expertise, skilled personnel, systems, procedures and equipment to account for, monitor, value and track its derivative positions and measure its risk. Again, the standards referred to in the proposal that is outlined in Section 25.03 are aimed at addressing and satisfying the needs in this respect.

The disclosure requirements with respect to the use of derivatives in an investment fund should be aimed at explaining how derivatives will be used to accomplish the stated fundamental investment policy and objectives of the investment fund. In this respect, in addition to the matters outlined in the proposal contained in Section 25.03, the adoption of recommendations such as those of the Accounting Standards Board of the CICA with respect to improving the quality of financial statement disclosure about positions in both derivatives and primary financial instruments would enhance the information that is available to investors. These recommendations (which have been issued as an exposure draft for comment) contemplate the inclusion of information about the extent, nature and terms of financial instruments, interest rate risk, credit risk, fair value and hedges of anticipated future transactions, and that this information will be presented in a context that highlights inter-relationships between primary financial instruments and derivative instruments. It is also suggested that there should be a discussion in either the financial

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Financial Instruments, Studies and Standards *Alert* dated July 4, 1994 published in CA Magazine, September 1994. I understand that the question of whether these recommendations prescribe the right standards or not is the subject of some debate. My purpose in referring to them is to highlight the need for better disclosure with respect to financial instruments. To this end, consideration should also be given to the proposed disclosure requirements in the recently issued FASB exposure draft "Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments", as well as to the disclosure requirements in SFAS 105, "Disclosure of Information about Financial Instruments with Off-Balance Sheet Risk and Financial Instruments with Concentrations of Credit Risk", and in SFAS 107, "Disclosures about Fair Value of Financial Instruments". Reference should also be made to the recently-announced SEC proposals to expand disclosure requirements covering derivatives used to hedge risk.

statements or the accompanying MD&A of such matters as the extent to which financial instruments are used, the risks associated with them, the business purposes they serve and management's policies for controlling the risks associated with financial instruments, including requirements for collateral, hedging of risk exposures and avoidance of undue concentration of risk. This suggestion is consistent with the proposals outlined in Section 25.03.

25.06 Securities Lending

The present restrictions on investment practices contained in National Policy No. 39 do not permit the lending of portfolio securities. In discussing with industry participants whether there should be any change in these restrictions to permit the lending of portfolio securities, some people expressed the view that the lending of portfolio securities should be permitted because it provides an additional source of revenue for the investment fund with relatively low risk. It was pointed out that depending upon the arrangement struck with the investment fund's custodian, custodial fees may be offset by the revenue derived from the lending of portfolio securities which would result in lower custodial fees and a corresponding reduction in the investment fund's management expense ratio.

Other people expressed the view that no change should be made in the current restrictions against the lending of portfolio securities. This was the prevailing view. The reasons given included observations that: (i) the benefit from securities lending is insignificant and is almost immaterial in terms of the investment fund's return, (ii) there are operational risks involved as well as credit risks, (iii) there is not enough additional revenue to warrant the risks involved, (iv) where related parties are involved who are also engaged in securities lending for their own account and others, there are concerns about whose securities will be lent first, whose securities will have the best collateral allocated to them, will the credit risk be increased by reason of substitutions, and whose loans will be called first? It was acknowledged that some of these concerns can be addressed by the contractual arrangements made with respect to securities lending but it was observed that there is still a concern that these provisions may not, in fact, be complied with and that legal action may have to be taken to enforce the contract, with there being no certainty that the investment fund would be able to recover the amount owing to it or the full amount of legal fees and expenses incurred to collect the amount. The conclusion of those who were not in favour of changing the current restrictions on securities lending was that such activity is not worth the credit and operational risks that are involved and that accordingly securities lending is not an appropriate activity for an open-end investment fund.

It was also noted that securities lending is a form of leverage and that if it were to be permitted, it should not be permitted to be used to increase the exposure of an investment fund.

Recommendation

I agree with these views and it is therefore my recommendation that no change be made in the restrictions contained in National Policy No. 39 with respect to the lending of portfolio securities.

26. CUSTODIANSHIP OF PORTFOLIO SECURITIES - NATIONAL POLICY NO. 39

Discussions with industry participants about the adequacy of the provisions of National Policy No. 39 regarding the custodianship of portfolio securities (including cash and cash equivalents) indicate that the current provisions appear to be working well. In particular, the decision made at the time of the adoption of National Policy No. 39 to focus on the choice of a suitable custodian and to place the responsibility on the custodian for ensuring that the sub-custodial arrangements that might be required to be entered into with respect to the assets held under the custodianship of the custodian are suitable and adequate appears to have been, and to remain, the right one. The provisions of National Policy No. 39 also place the responsibility on the custodian for monitoring compliance with the requirements of National Policy No. 39 with respect to the sub-custodial arrangements (including the continued compliance with the eligibility criteria for acting as a sub-custodian) and the custodian is required to make periodic reports in this respect.
This approach differs from that of the SEC insofar as the SEC's approach requires the board of directors of the investment fund to be more directly involved with overseeing the choice of and the activities of sub-custodians.

For example, the SEC requirements require the board of directors of the investment fund to: (i) determine that maintaining the portfolio securities of the investment fund in a particular country or countries and with a particular custodian or sub-custodian is consistent with the best interests of the investment fund and its securityholders, (ii) determine that the agreement(s) to be entered into with any custodian or sub-custodian that will govern the manner in which such custodian or sub-custodian will maintain the portfolio securities of the investment fund is consistent with the best interests of the investment fund and its securityholders and complies with the requirements of the SEC, (iii) establish systems to monitor custodial and sub-custodial arrangements to ensure compliance with SEC requirements, (iv) review and approve, at least annually, whether the continuance of such custodial and sub-custodial arrangements is consistent with the best interests of the investment fund and its securityholders, (v) if it is determined that a custodian or sub-custodian may no longer be considered eligible to continue to act or the arrangement would not otherwise be consistent with the best interests of the investment fund and its securityholders, to cause the portfolio securities to be withdrawn from the care of that custodian or sub-custodian and transferred to another eligible custodian or sub-custodian, as the case may be, as soon as reasonably practicable, and in any

Some people have suggested that the current requirements of National Policy No. 39 should be more closely aligned with the SEC's requirements by placing on the manager of the investment fund and on any board of the investment fund the responsibility (that is currently on the custodian) for choosing sub-custodians and for monitoring their compliance with the requirements of National Policy No. 39. The reason given for making this suggestion is based on the importance of the manager of an investment fund and any board of the investment fund being knowledgeable about the custodial arrangements and having a more pro-active role with respect to them.

In my opinion, this heightened awareness of the investment manager and of the board can be achieved without changing the focus of the current requirements of National Policy No. 39 and I do not see any advantage to be gained by changing the focus. Instead, I see real disadvantages in changing such focus both from an administrative point of view and from a substantive point of view as it is unlikely that an individual investment fund or manager of an investment fund will have the expertise or the "clout" to deal with a myriad of sub-custodians all over the world and with any problems that may arise with respect to settlement and delivery of securities or otherwise.

At most, I think that there is a need for heightened awareness by the investment fund manager and the board of an investment fund of the issues involved in global trading and the importance of understanding and becoming familiar with the relevant laws of the relevant jurisdictions where investments are being made, with a view to being satisfied as to the appropriateness of investing in these jurisdictions and the maintenance of fund assets in such jurisdictions. In this context, the process of the investment fund manager and the board of the investment fund satisfying themselves as to the appropriateness of the choice of the custodian, the appropriateness of the custodian's sub-custodial arrangements, the provisions of the relevant laws of the relevant jurisdictions, and the sufficiency of the internal controls and operating procedures of the custodial network on a continuing basis would appear to be encompassed by normal "due diligence" procedures

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event within 180 days of the date when the determination was made.

The SEC, in its notes to the rules under Section 17 of the Investment Company Act of 1940, gives some guidance on relevant matters that should be kept in mind by a board in carrying out its fiduciary duties with respect to the selection of a country where assets are to be maintained. These matters include, but are not limited to, whether foreign laws restrict: (i) the access to books and records of the custodian or suband should not have to be mandated. I understand that investment fund managers and the boards of investment funds are focussing increasingly on these matters and have, or are putting in place, procedures in this respect.

26.01 Audit Reports - Custodians and Sub-Custodians

It has been suggested that it should be a requirement that the custodianship and sub-custodianship agreements that are entered into:

(i) permit the auditors of the investment fund to have access to the books and records of the custodian and sub-custodian that pertain to the portfolio securities of the investment fund in their custody for the purpose of their audit or, upon request of such auditors, provide for the auditors to be provided with confirmation of the contents of those books and records; and

(ii) require each custodian and sub-custodian to cause their independent auditors to provide the equivalent of a Section 5900 Report with respect to their requisite internal controls and operating procedures, such audit report to be provided at least twice a year with each custodian and sub-custodian providing compliance certificates for the intervening quarterly periods and provision being made for surprise audits; the Section 5900 Reports should be required to be filed with the Securities Regulator.

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custodian, (ii) the investment fund's ability to recover assets that are lost while under the control of the custodian or sub-custodian, the likelihood of expropriation, nationalization, freeze or confiscation of the investment fund's assets and whether difficulties in converting the investment fund's cash and cash equivalents to US dollars are reasonably foreseeable. With respect to determinations respecting the selection of a custodian or sub-custodian, the relevant matters include, but are not limited to: (i) a consideration of the financial strength of the custodian or sub-custodian, its general reputation and standing in the country in which it is located, its ability to provide efficiently the custodial services required and the relative cost for these services, (ii) whether the custodian or sub-custodian would provide a level of safeguards for maintaining the investment fund's assets not materially different from that provided by the investment fund's American custodian in maintaining the investment fund's assets in the United States, (iii) whether a foreign custodian or sub-custodian has branch offices in the United States in order to facilitate the assertion of jurisdiction over and enforcement of judgments against such custodian or sub-custodian, and (iv) in the case of a foreign securities depository, the number of participants in, and operating history of, the depository. The extent of the investment fund's exposure to loss and the potential effect thereof upon securityholders is required to be disclosed, if material, in the investment fund's prospectus.

Recommendation

It is my recommendation that this suggestion be adopted subject to the follow on work arising out of this report addressing whether the suggested frequency of the Section 5900 Report is appropriate.

26.02 Independent Custodian

The views of industry participants about whether an investment fund should be required to appoint an independent custodian were mixed and were heavily influenced by the reality of the Canadian marketplace. On balance, most people were comfortable with maintaining the present status subject to the addition of the requirement referred to in Section 26.01 for a Section 5900 Report (or its equivalent). Most people considered that the addition of external verification requirements of the adequacy of, and compliance with, the custodian's internal controls and procedures that would be achieved through the requirement for a Section 5900 Report to be sufficient protection for investors when taken together with:

(1) the fiduciary obligations of the investment fund manager (and of any board of the investment fund), and

(2) the current requirements of National Policy No. 39 with respect to:

 (i) the eligibility requirements that must be met in order to act as a custodian or sub-custodian,

 (ii) the requirements that the assets of an investment fund must be segregated from those of any other person or entity, and

 (iii) the requirements that the assets of an investment fund must be registered in the name of the investment fund or a nominee for such investment fund.

As a practical matter, I agree with such submissions. However, I think that this is an area that should be monitored by the Securities Regulator on a pro-active basis with respect to both compliance with the requirements of National Policy No. 39 and with respect to considering the sufficiency of the requirements in the light of experience in a changing marketplace.

26.03 Responsibilities of Investment Fund Managers and Boards

The safekeeping of the assets of an investment fund is one of the most important responsibilities of the investment fund manager and of the board of an investment fund. It is an area that should be monitored on a continuous basis to ensure the adequacy of the safekeeping arrangements and of the controls and procedures relating to the same. The review of this function cannot just be left to the regulators. Such review is and must be part of the essential business operations and responsibilities of the investment fund manager and the board. Accordingly, the prime responsibility for ensuring compliance with the requirements of National Policy No. 39 is and must remain with the investment fund manager and the board of an investment fund. The fact that the Securities Regulator may also be monitoring this matter does not and should not in any way diminish these responsibilities.

Some questions that have been raised with me that I think require review by investment fund managers and boards, with appropriate action being taken where needed to protect the assets of investment funds, include:

(1) Are the cash balances and cash equivalents that belong to the investment fund adequately segregated and imprest as funds held in trust for the investment fund? Are they free from the claims of creditors of the financial institution where they may be kept and/or the claims of creditors of the investment fund manager or any related party?

(2) What problems have there been with settlements? Are transactions being settled within the normal settlement period? What is the normal settlement period? Is this period reasonable? Is the investment fund exposed to risk if the trade does not settle?

(3) What is the frequency of transactions that are entered into and then cancelled before settlement? What impact is this having on the determination of the net asset

value of the investment fund?

(4) Is there an adequate understanding of how local markets operate and what the implications may be to the investment fund?

26.04 Assets Held in a Book-Based System

A suggestion was made that where the assets of an investment fund are all "book-based", there is no need to appoint a separate custodian to hold these assets for the investment fund. In this respect, it was suggested that where the investment fund manager is a clearing member of a self-regulatory organization and is a member of The Canadian Depository for Securities (which operates a book-based system for securities of Canadian issuers) and of the Canadian Investor Protection Fund, such member should be permitted to act as the custodian of an investment fund which it manages if all of the assets of such investment fund consist of securities that are deposited with The Canadian Depository for Securities.

I am not making any recommendations in this respect. The purpose of mentioning the suggestion is only to indicate that as an ongoing matter, as securities become increasingly book-based, it may be desirable, in the interests of streamlining processes by removing an intermediary that may no longer be necessary, lowering costs and improving efficiency, to adjust the custodial requirements to reflect changes in the way that securities transactions are completed.

27. MISCELLANEOUS MATTERS - NATIONAL POLICY NO. 39

During the course of discussions with industry participants there were a variety of other matters that were raised with respect to matters covered by National Policy No. 39. The major ones are outlined below.

27.01 Prohibition Against Reimbursement of Organizational Costs

Section 3.02 of National Policy No. 39 provides that the costs of establishing and organizing an investment fund (including the costs of the preparation and filing of the initial preliminary and final prospectus) are to be borne by the promoter, sponsor or manager of the investment fund and that the investment fund is not to reimburse any of them for their expenses or assume any of such expenses.

Notwithstanding this prohibition, the practice has been to carry these costs on the balance sheet of an investment fund and to write them off over a five year period. People have commented that this is a way of requiring the investment fund to pay these expenses and the fact that payment is deferred over a five year period does not change the character of the expenses. It is my recommendation that this practice should cease and that the provisions of Section 3.02 should be required to be complied with.

27.02 Management Expense Ratio

I understand that the practice in calculating the management expense ratio is not to deduct as an expense of the investment fund the goods and services tax that is payable by the investment fund because Section 8.03(4)(b) of National Policy No. 39 excludes from the definition of fees and other expenses, "taxes of all kinds to which the investment fund is subject". In this respect, I note that the definition of "fees and expenses" contained in this subsection predated the imposition of a goods and services tax. At the time that the definition was developed, the only taxes to which an investment fund, as a practical matter, was subject were taxes on income and capital gains and only these taxes were intended to be excluded. As the goods and services tax is an expense of the investment fund, the fact that it is not being deducted in determining the management expense ratio distorts the information that the management expense ratio is intended to convey. Accordingly, I recommend that the definition of fees and expenses be changed to provide that the goods and services tax and any provincial sales tax or similar taxes that are paid or payable by the investment fund be included as one of the expenses of the investment fund in determining its management expense ratio.

This provision is an extension of the traditional basic principle that the costs of distribution should be borne by the principal distributor/manager and not by the investment fund.

Although an investment fund was also subject to paying provincial sales taxes on tangible goods that it purchased, most investment funds did not purchase any such goods. At the time in question, the usual arrangement between an investment fund manager and its sponsored investment funds was that the Investment fund manager would provide its sponsored investment funds with whatever such funds required in the ordinary course of their activities in consideration for the management fee charged to the investment fund.

27.03 Short-Term Trading by Investors

One of the changes made at the time that National Policy No. 39 was adopted was the elimination of the requirement that there be a redemption fee payable by investors to an investment fund if an investor redeemed the securities that he or she had purchased within 90 days of such purchase. The maximum fee was 2% of the purchase price and the purpose of the fee was to discourage short-term trading by investors which negatively impacted on the investment fund by reason of there being increased administrative and transaction costs as well as opportunity costs arising out of the need to retain larger than normal cash positions to fund short-term redemptions.

People have mentioned that the practices that led up to the imposition of the short-term redemption fee are again occurring and that it would be in the interests of investors to discourage such practices by re-instating the requirement for a short-term redemption fee that would be retained by the investment fund. It is my recommendation that this be done.

On a related matter, I understand that there have been problems with investors who want to redeem the securities that they have purchased in an investment fund before their cheque in payment of the purchase price has cleared. This exposes the distributor and the investment fund to loss when the investor's cheque does not clear. It would seem that a situation of this nature would best be handled by the adoption of administrative procedures that do not permit redemption proceeds to be paid unless and until the investor's cheque in respect of the purchase of such securities has cleared. A provision of this nature could be reflected as an exception to the requirements to pay the redemption proceeds within the time period stipulated in National Policy No. 39.

27.04 Compliance with Sections 11 and 12 of National Policy No. 39

The provisions of Sections 11 and 12 of National Policy No. 39 are aimed at: (i) ensuring that an investor's funds which are to be invested in an investment fund are received promptly by the investment fund, and (ii) eliminating or at least reducing the opportunity for loss of an investor's funds during the period from the delivery of such funds by the investor to the time of receipt of such funds by the investment fund. In addition, the provisions are aimed at ensuring that the interest earned on an investor's funds during the period from the delivery of such funds by the investor to the time of receipt of such funds by the investment fund accrues to the benefit of either the investment fund or the investor and, vice versa, in the case of redemptions. Compliance reports with respect to these matters are required to be filed on an annual basis and are required to be accompanied by a letter from external auditors verifying whether such auditors are in agreement with the information given in the report with respect to compliance.

I am told that compliance reports are being filed that detail substantial non-compliance with the requirements of Section 11 and 12 and that there is no follow-up of these matters with the persons involved. This weakens the effectiveness of these provisions to accomplish the purposes outlined above. I believe it to be essential that there is appropriate follow-up activity when a compliance report indicates that there has been non-compliance with the requirements of Section 11 and 12. Matters such as these should go to the issue of continuing fitness for registration of distributors. I recommend that the Securities Regulator, with the assistance of the existing self-regulatory organizations, take a more pro-active role with respect to these matters which are basic elements of investor protection.

27.05 Commingling of Money by Financial Institutions

I have been told that some financial institutions that are principal distributors or sub-distributors of investment funds are not segregating in a separate interest-bearing account the money received from investors for the purchase of securities of investment funds or that is payable to investors on the redemption of securities of investment funds. I have been told that these financial institutions regard the fact that they are subject to capital requirements and to investment restrictions with respect to the use of such funds that are prescribed in federal and/or provincial financial institutions legislation as providing sufficient protection to investors.

People have raised concerns with me about this matter both from the perspective of whether investors are protected against the claims of creditors of the financial institutions in the event of the insolvency of the financial institution and from the perspective of there being a level playing field.

I believe that it would be desirable to review this area to be sure that as a minimum, the arrangements made by financial institutions are sufficient to protect investors' assets from the claims of third parties and that the requirements and practices be brought into line with what, if anything, is required in order to do this.

27.06 Settlement Dates and Error Corrections

As noted in Section 13.02, there is a need to address the provisions of Sections 11, 12 and 13 of National Policy No. 39 with respect to: (i) shortening the periods for settling both purchases and redemptions of investment fund securities to "T+3", (ii) providing for timely transfers from one registered retirement plan to another, (iii) dealing with the extent to which net settlements may be permitted, and (iv) establishing industry standards for error correction procedures that do not involve back pricing of orders.

27.07 Computation of Net Asset Value

There appears to be increasing flexibility developing with respect to how net asset value is being determined. Apart from the need referred to in Section 24.03 to develop standards with respect to the determination of net asset value from the perspective of the comparability of performance information, there is a need for certainty with respect to how net asset value is being determined to ensure fairness to investors and not to allow some investors to gain at the expense of others.

To this end, it is my recommendation that the rules for determining the net asset value of an investment fund (including rules as to how assets and liabilities are to be valued, income, expense and capital items are to recognized and how the calculation is to be made) be specified in the constating documents of the investment fund and that these rules not be permitted to be changed without an amendment to the constating documents being required that has been authorized by the securityholders of the investment fund.

If the power is reserved to change any aspect of the rules - such as the Valuation Date or the time of day as of which the net asset value is to be calculated - such change should not be permitted to be made without prior notice of the change being required to be given to the securityholders and such notice being required to be filed with and accepted by the Securities Regulator. There should be no opportunity for "private valuations" that allow some investors to purchase or redeem at a price that other investors are not able to.

27.08 Realized and Unrealized Gains on Investments

One of the issues raised with me was whether realized and unrealized gains (losses) on investments should be permitted to be reflected in the calculation of net investment income that is included in the statement of operations that forms part of the financial statements of an investment fund. The inclusion of this figure results in a higher margin of profitability on operations being reflected than is actually the case.

It is my recommendation that the net investment income per unit should be required to be measured and reflected excluding realized and unrealized gains (losses) on investments. This recommendation conforms with what I am told are the requirements in this respect that are in effect in the United States and also conforms with the requirements contained in Section 83(1) of the Regulation made under the Securities Act (Ontario).

27.09 Fundamental Changes

Section 6.01 of National Policy No. 39 outlines fundamental changes that require the approval of securityholders before they may be implemented. Included in these changes are: (i) changes in the basis of the calculation of the fees or other expenses that are charged to an investment fund which could result in an increase in charges to the investment fund, (ii) a change of manager of the investment fund, and (iii) a change in the fundamental objectives of an investment fund. Two major issues have been raised with me about this matter.

The first issue relates to the need to be sure that investors and existing securityholders are informed about impending changes. Something more than just complying with the legal requirements respecting obtaining securityholder authorization for the changes is needed in order to highlight the fact that the changes have occurred. I believe that the recommendations that I have made concerning basic disclosure requirements, material change reports and MD& A in annual and interim reports would, if implemented, address this need.

The second issue relates to providing securityholders with an opportunity to redeem their securities without penalty and, in certain circumstances, (such as those referred to in Section 17.04), to receive a refund of sales charges paid, for a period of time - e.g. for a period commencing on the date that notice of the proposed fundamental change is given and ending 60 days following the effective date of the fundamental change. Fairness would favour there being such an opportunity and I recommend that there be follow-on work to develop requirements in this respect.

28. CONCLUSION

The reaction of some who read this report will be that the recommendations contained herein are calling for a lot of regulation and that not only is this inconsistent with current trends that favour deregulation, it is putting too great a cost on the regulatory system and on the industry. I do not agree with either perspective.

With respect to the issue of the "cost" to the regulatory system and to the industry of the recommendations contained in this report, the recommendations contained herein are directed at designing a regulatory system that will address the needs resulting from the industry-driven shift from a transactions-based industry to a relationship-based industry. This shift requires significant investments in education, systems, training and back office operations as well as the modification of compensation structures to reflect the strategic changes in the way in which, and what business, is done. Failure to make such investments, in my opinion, will impose substantial costs on the competitive position of the industry and on the efficacy of the regulatory framework.

With respect to the "regulation/deregulation" issue, it would be most unfortunate if this theme were to be allowed to deflect attention away from the substance of the recommendations contained in this report which are focussed on providing a structure for better, more effective and more efficient regulation. "Deregulation" does not mean that there will be "no regulation" unless it can be clearly established that "no regulation" is needed. In the case of the investment fund industry in Canada, this has not even been suggested. On the contrary, it is abundantly clear from what is happening in the industry today that there is a need for better, more effective and more efficient regulation that will result in investors being fairly and equitably treated.

The core challenge is to what extent the industry is prepared to take hold of the matters that require regulation and to operate a self-regulatory system that will deal effectively and efficiently with the issues raised in this report and that will result in fair and equitable treatment of investors.

The issues are clearly outlined in this report. They go not only to the heart of the investment fund industry but to the heart of the securities industry as a whole. They centre on the distribution process, conflicts of interest, and the difficulties that the current regulatory structure presents to efforts to deal meaningfully with these issues from either a structural or a substantive point of view.

Vision and leadership are required to deal with all of these matters and must come from both the industry and the regulators.

29. IMPLEMENTATION

As indicated at the beginning of this report, my basic approach has been to identify the major issues that need to be addressed by the industry and by the regulators and to suggest how to best address them. This having been done, the question is: "What happens now?".

I recommend that the starting point of the next phase of the process be to ascertain whether there is concurrence with the underlying strategies suggested in my recommendations for:

- # Centralized, coordinated, streamlined, functional regulation

- # Strong effective, self-regulation by the industry based on:

- ! high ethical standards
- ! fair practice and business conduct rules
- ! effective and efficient systems, controls and procedures
- ! pro-active and timely monitoring

\# Improved corporate governance provisions in respect of investment funds

\# Increased emphasis on educational and proficiency requirements for industry participants aimed at providing industry participants with:

- ! better training and proficiency skills
- ! better awareness of ethical standards, fair practice and business conduct rules
- ! better ability to meet client needs and expectations

\# Increased emphasis on the importance of investor education aimed at improving the ability of investors to:

- ! identify, request, review and understand the information needed to assess investment recommendations made to them
- ! apply the information to their own situation in making investment decisions
- ! identify, request and review in a meaningful manner the information needed to monitor their investment on a continuing basis and assess whether adjustments are needed

\# Realignment of the elements of the disclosure system aimed at:

- ! integrating primary and secondary disclosure requirements
- ! improving disclosure requirements to ensure that the information is relevant, timely and meaningful
- ! ensuring that disclosure is integrated and continuing

- # Establishment of a basis for achieving comparability of performance information about different investment products and between investment products of the same type

- # Establishment of a steering group to coordinate the follow-on work arising out of this report

If there is concurrence with these strategies, I suggest that the next step in the process should be to establish a steering group to coordinate the follow-on work arising out of this process.

I suggest that the steering group be composed of regulatory and industry personnel, with sufficient practical experience and stature in the industry who are able to oversee and manage the process of responding to the various recommendations in the report, effectively and efficiently. To this end, it is my recommendation that the steering group be kept relatively small and that the persons who are members of the steering group be in a position to dedicate a substantial amount of their time and effort to the work of the steering group, with priority being given to the work that is to be done.

I suggest that the steering group, in organizing this work, might divide the recommendations that are made in this report into three categories:

- ! those that need to be primarily addressed by securities and other regulators;

- ! those that need to be primarily addressed by the industry; and

- ! those that need to be primarily addressed jointly by the regulators and the industry.

I suggest that sub-groups, reporting to the steering group, be established to coordinate the work within each of the above categories. It will likely be necessary, within each category, to establish project teams to work on specific matters. Again, it will be important that the sub-groups be kept relatively small and be composed of personnel, with sufficient practical experience and stature in the industry and regulatory world, who will be able to oversee and manage the process of responding to the various recommendations in the report, efficiently and effectively. The persons serving on these sub-groups need to be in a position to dedicate a substantial amount of their time and effort to the work of the sub-group, with priority being given to the work that is to be done. In the case of the project teams, it will be important to staff them with skilled, knowledgeable people who will dedicate, on a short-term basis, their full-time and attention to their tasks and then be available for any fine-tuning work that may be required to be done.

To the extent that legislative action is required as a result of the work that is done, I suggest that the steering group will be in the best position to approach the appropriate governmental authorities with proposals for legislative action and to coordinate with such governmental authorities any preliminary work that is required to be done in this respect.

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I have made the recommendations in this report in the expectation that regulators and industry participants alike will be pro-actively engaged in the work that is required to operationalize and implement the recommendations. In doing so, I was encouraged by the high calibre of the knowledge and experience of so many of the people with whom I have worked in the course of preparing this report and of their willingness to share and to apply their knowledge and experience to the issues at hand. I hope that the momentum that has begun will not be lost and that the persons who will be subject to, and will work in, the proposed new regulatory structure and system will flesh out the details required to implement the proposed strategic directions.

Glorianne Stromberg
January 17, 1995
Toronto, Ontario

SCHEDULE ONE

Statistical Information and Graphs Prepared by The Investment Funds Institute of Canada Relating to the Canadian Mutual Fund Industry

1. Statistical Overview at October 31, 1994
2. Historical Overview, Canadian Mutual Funds Industry - IFIC Members
3. Market Share by Distribution Channel at October 1994
4. Total Assets at Year End - December 31, 1982 to 1993
5. Total Net Assets - January to October 1994 and Year End December 31, 1991 to 1993
6. Total Net Assets by Fund Type - October 1993 and 1994 and Year to Date December 31, 1993
7. Total Net Assets by Fund Type - October 1993 and 1994 and Year to Date December 31, 1993 (continued)
8. Total Net Sales at Year End - December 31, 1982 to 1993
9. Total Net Sales January to October 1994 and Year End December 31, 1991 to 1993
10. Net Sales by Fund Type - October 1993 and 1994 and Year to Date December 31, 1993
11. Net Sales by Fund Type - October 1993 and 1994 and Year to Date December 31, 1993 (continued)

SCHEDULE TWO

Recommendations of the Investment Company Institute's Advisory Group on Personal Investing

The Report of the Advisory Group on Personal Investing dated May 9, 1994 (the "ICI Report") recommends, among other things, that each fund adopt the following restrictions and procedures with respect to the personal investing and other activities of its investment personnel:

- investment personnel should be prohibited from acquiring any securities in an initial public offering ("IPO") and should be strictly limited in their ability to participate in private placements of securities;

- each fund manager should be subject to "blackout periods" during which he would be prohibited from buying or selling securities for seven days before and after the fund he manages purchases or sells the same securities, and other investment personnel should be prohibited from buying or selling securities on a day during which the fund or any other fund in the same fund group has a pending buy or sell order for those securities;

- investment personnel should be prohibited from profiting from the purchase and sale, or the sale and purchase, of the same securities within 60 days, and any profits realized on any such short-term trades should be required to be disgorged;

- investment personnel should be prohibited from serving on the boards of

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[1] As used in the ICI Report, the term "investment personnel" is essentially synonymous with the term "access person" as defined in rule 17j-1 of the SEC. "Access persons" of an entity generally include officers, directors and any employees who participate in the selection of a fund's portfolio securities or who have access to information regarding a fund's impending purchases and sales of portfolio securities.

directors of publicly traded companies, absent prior authorization based upon a determination that the board service would be consistent with the interests of the fund and its shareholders;

- investment personnel should be prohibited from receiving any gift or other thing of more than *de minimis* value from any person or entity that does business with, or on behalf of, the fund;

- investment personnel should be required to pre-clear all personal securities transactions;

- investment personnel should be required to disclose to the fund all personal securities holdings at the commencement of employment and annually thereafter;

- investment personnel should be required to instruct their brokers to send copies of trade confirmations and account statements directly to their employers;

- appropriate procedures should be implemented by the fund to monitor personal investment activity by access persons after per-clearance has been granted;

- access persons should be required to certify annually that they have read and understood the fund's code of ethics and recognize that they are subject to it; and

- fund management should submit to the fund's board of directors or trustees an annual report summarizing, among other things, any changes made during the past year to the fund's procedures governing personal investing by access persons and identifying any violations of the procedures by an access person requiring significant remedial action during the past year.

The ICI Report also recommends that funds disclose in their prospectuses or, at a minimum, their statements of additional information, the policies applicable to personal investing by their access persons. In addition, the Report recommends that the NASD adopt a rule requiring all broker-dealers to notify a registered investment adviser when any of the adviser's employees opens a brokerage account.

Although it contemplates that "substantive standards [relating to personal investing] should apply across the industry," the ICI Report acknowledges that "[i]ndividual investment companies, of course, may elect to implement more rigorous standards should these by deemed more appropriate in a specific case." Moreover, the Report states that a guiding principle in drafting its recommendations was that "flexibility to allow investment companies to tailor restrictions to unique or exceptional circumstances is critical to successful implementation of [the] standards [reflected in the recommendations.]" Reflecting this principle, the Report does not advocate that the SEC adopt the Report's recommendations as rules under the 1940 Act.

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[1] Forms N-1A and N-2, the forms for registering open-end and closed-end investment companies, respectively, under the Securities Act and the 1940 Act, provide for a prospectus and a separate "statement of additional information" ("SAI"). The SAI, which is available upon request, is designed to provide shareholders with information about the registrant that is not required to be included in the prospectus but that may be of interest to at least some investors.

[2] ICI Report, *supra*, at page 26.

[3] Id.

SCHEDULE THREE

1. Sample of a Morningstar OnDemand Mutual Fund Report together with the Morningstar OnDemand Mutual Funds User's Guide.

2. Sample of a Bell Charts Investment Profile Report and User's Guide

SCHEDULE FOUR

Extract (edited to remove names and numbers) from a Statement of Additional Information filed with the SEC by an American investment fund. Attention is drawn to the definition of "best execution" which is contained in paragraph 1 of the extract.

"BROKERAGE ALLOCATION

The Investment Management Agreement provides that the Investment Manager is responsible for selecting members of securities exchanges, brokers and dealers (such members, brokers and dealers being hereinafter referred to as "brokers") for the execution of the Fund's portfolio transactions and, when applicable, the negotiation of commissions in connection therewith. All decisions and placements are made in accordance with the following principles:

1. Purchase and sale orders are usually placed with brokers who are selected by the Investment Manager as able to achieve "best execution" of such orders. **"Best execution"** means prompt and reliable execution at the most favorable securities price, taking into account the other provisions hereinafter set forth. The determination of what may constitute best execution and price in the execution of a securities transaction by a broker involves a number of considerations, including, without limitation, the overall direct net economic result to the Fund (involving both price paid or received and any commissions and other costs paid), the efficiency with which the transaction is effected, the ability to effect the transaction at all where a large block is involved, availability of the broker to stand ready to execute possibly difficult transactions in the future, and the financial strength and stability of the broker. Such considerations are judgmental and are weighed by the Investment Manager in determining the overall reasonableness of brokerage commissions.

2. In selecting brokers for portfolio transactions, the Investment Manager takes into

account its past experience as to brokers qualified to achieve "best execution," including brokers who specialize in any foreign securities held by the Fund.

3. The Investment Manager is authorized to allocate brokerage business to brokers who have provided brokerage and research services, as such services are defined in Section 28(e) of the Securities Exchange Act of 1934 (the "1934 Act"), for the Fund and/or other accounts, if any, for which the Investment Manager exercises investment discretion (as defined in Section 3(a)(35) of the 1934 Act) and, as to transactions as to which fixed minimum commission rates are not applicable, to cause the Fund to pay a commission for effecting a securities transaction in excess of the amount another broker would have charged for effecting that transaction, if the Investment Manager in making the selection in question determines in good faith that such amount of commission is reasonable in relation to the value of the brokerage and research services provided by such broker, viewed in terms of either that particular transaction or the Investment Manager's overall responsibilities with respect to the Fund and the other accounts, if any, as to which it exercises investment discretion. In reaching such determination, the Investment Manager is not required to place or attempt to place a specific dollar value on the research or execution services of a broker or on the portion of any commission reflecting either of said services. In demonstrating that such determinations were made in good faith, the Investment Manager shall be prepared to show that all commissions were allocated and paid for purposes contemplated by the Fund's brokerage policy; that the research services provide lawful and appropriate assistance to the Investment Manager in the performance of its investment decision-making responsibilities; and that the commissions paid were within a reasonable range. The determination that commissions were within a reasonable range shall be based on any available information as to the level of commissions known to be charged by other brokers on comparable transactions, but there shall be taken into account the Fund' policies that (i) obtaining a low commission is deemed secondary to obtaining a favorable securities price, since it is recognized that usually it is more beneficial to the Fund to obtain a favorable price than to pay the lowest commission; and (ii) the quality, comprehensiveness and frequency of research studies which are provided for the Investment Manager are useful to the Investment Manager in performing its advisory services under its Agreement with the Fund. Research services provided by brokers to the Investment Manager are considered to be in addition to, and not in lieu of, services required to be performed by the Investment Manager under its

Contract with the Fund. Research furnished by brokers through whom the Fund effects securities transactions may be used by the Investment Manager for any of its accounts, and not all such research may be used by the Investment Manager for the Fund. When execution of portfolio transactions is allocated to brokers trading on exchanges with fixed brokerage commission rates, account may be taken of various services provided by the broker, including quotations outside the United States for daily pricing of foreign securities held in the Fund's portfolio.

4. Purchases and sales of portfolio securities within the United States other than on a securities exchange are executed with primary market makers acting as principal, except where, in the judgment of the Investment Manager, better prices and execution may be obtained on a commission basis or from other sources.

5. Sales of the Fund's Shares (which shall be deemed to include also shares of other companies registered under the 1940 Act which have either the same investment manager or an investment manager affiliated with the Investment Manager) made by a broker are one factor, among others, to be taken into account in deciding to allocate portfolio transactions (including agency transactions, principal transactions, purchases in underwriting or tenders in response to tender offers) for the account of the Fund to that broker; provided that the broker shall furnish "best execution," as defined in paragraph 1 above, and that such allocation shall be within the scope of the Fund's other policies as stated above; and provided further, that in every allocation made to a broker in which the sale of Shares is taken into account there shall be no increase in the amount of the commissions or other compensation paid to such broker beyond a reasonable commission or other compensation determined, as set forth in paragraph 3 above, on the basis of best execution alone or best execution plus research services, without taking account of or placing any value upon such sale of Shares.

Insofar as known to management, no Trustee or officer of the Fund has any material direct or indirect interest in any broker employed by or on behalf of the Fund. [**M**], which acts as the Fund's Sub-Adviser through its InterCapital Division, may act as broker on behalf of the Fund and receive commissions on such transactions. [**M**], the Fund's Principal Underwriter, is a registered broker-dealer, but has never executed any purchase or sale transactions for the Fund's portfolio or participated in any commissions on any such transactions, and has no intention of doing so in the future. The total brokerage commissions on the portfolio transactions for the Fund during the fiscal years ended December 31, 199[**M**] and 199[**M**] and the fiscal period from [**M**] (commencement of operations) through December 31, 199[**M**], and the amount of such commissions on transactions allocated to [**M**] on the basis of best execution, investment information and trading desk services, were as follows: total commissions (not including any spreads or concessions on principal transactions) were [$**M**], [$**M**] and [$**M**], respectively. All portfolio transactions are allocated to broker-dealers only when their prices and execution, in the good faith judgment of the Investment Manager, are equal or superior to the best available within the scope of the Fund's policies. The Fund will not purchase or sell any securities on the over-the-counter market from or to [**M**] acting as principal for its own account. There is no fixed method used in determining which broker-dealers receive which order or how many orders."

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