FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

July 25, 2011

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RE: Request For Comment On Phase 2 Proposals

FAIR Canada is pleased to offer comments on the proposed assessment of the current regulatory framework that applies to different types of publicly offered investment funds by the CSA. In particular, FAIR Canada will provide comments relating to the Canadian Securities Administrators' (the "CSA") Phase 2 Proposals for the modernization of investment fund product regulation project contained in CSA Staff Notice 81-322 published as (2011) 34 OSCB 6092 (the "Notice") on May 26, 2011.

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

FAIR Canada Comments and Recommendations – Executive Summary:

1. FAIR Canada believes that further and more fundamental changes in investment funds regulation beyond the CSA's Modernization Project are necessary and proposes that regulators should adopt a principle requiring industry participants to put the best interests of their clients first (a "Clients First Model"). The Clients First Model we envision would include:
    - 1.1. a requirement that advisors and firms put the interests of their clients foremost;
    - 1.2. the tightening and enforcement of conflicts of interest rules for advisors and other registrants;
    - 1.3. more robust regulation and enforcement of advertising and marketing rules for investment funds;
    - 1.4. a comprehensive review of the exempt market, particularly the accredited investor rules;
    - 1.5. increased investor protection in the exempt market, including a requirement that exempt market dealers be members of an SRO, backed by a compensation fund; and
    - 1.6. the development of knowledge and training standards for exempt market dealers for certain types of investment products.

2. FAIR Canada encourages the CSA to adopt point-of-sale disclosure rules for non-redeemable investment funds but cautions that any attempt to improve investor protection primarily through disclosure will be inadequate.
3. We reiterate representations made in our Phase 1 comments regarding the regulatory regime for closed-end funds, which should be extended where appropriate to non-redeemable funds.
4. The CSA's proposed specific protections for investors in non-redeemable funds are appropriate and will enhance investor protection, but we wish to emphasize the need for greater regulatory oversight and question the Independent Review Committee model for dealing with conflict and self-dealing issues.
5. We caution the CSA that a stand-alone rule for non-redeemable funds may be less useful for investor protection than a blanket rule covering all collective investment funds, with appropriate stand-alone rules for various types or classes of funds.
6. It is important that non-redeemable funds be subject to anti-tiering rules to prevent fee stacking, and be subject to strict point-of-sale disclosure requirements which require managers to outline how their investment practices will differ from those of open-end mutual funds.

We will also respond to each of the specific questions raised by the CSA in the Notice. Although it is difficult to provide specific comments without understanding the final shape of the Phase 1 amendments (which are stated in the Notice to be published in final form in late summer 2011), we will provide responses to the questions that are as complete as possible.

1. FAIR Canada Supports the Modernization Project and the Phase 2 proposals.

1.1. FAIR Canada continues to support the CSA's Modernization Project and we offer our support for the Phase 2 Proposals and the attempt to harmonize the rules pertaining to investment funds. We support the CSA's objective of identifying and addressing market efficiency, investor protection and fairness issues that arise out of the differing regulatory regimes that apply to different types of publicly offered investment funds.

1.2. FAIR Canada believes that further and more fundamental changes in investment funds regulation beyond the CSA's Modernization Project are required, and proposes that regulators should adopt a principle requiring industry participants to put the best interests of their clients first (a "Clients First Model"). FAIR Canada is concerned that the CSA's Modernization Project represents an endorsement of the existing Canadian regulatory framework and we are of the opinion that the existing regulatory framework is not functioning well enough to provide adequate investor protection. The Clients First Model we envision would include: 1) a requirement that advisors and firms put the interests of their clients foremost; 2) the tightening and enforcement of conflicts of interest rules for advisors and other registrants; 3) more robust regulation and enforcement of advertising and marketing rules for investment funds; 4) a comprehensive review of the exempt market, particularly the accredited investor rules; 5) increasing investor protection in the exempt market, including a requirement that exempt market dealers be members of an SRO, backed by a compensation fund; and 6) development of knowledge and training standards for exempt market dealers for certain types of investment products. FAIR Canada considers such developments necessary, and cautions that any attempt to improve investor protection primarily through disclosure will be inadequate.

1.3. Although FAIR Canada welcomes the adoption of point-of-sale disclosure rules for non-redeemable investment funds (see section 2 below) this can only succeed in protecting investors when combined with further fundamental reforms in the promotion and sale of investment funds. If regulators rely on

disclosure alone to protect investors in investment fund products, the burden of responsibility shifts onto the unsophisticated retail investor. The disclosure of long lists of material facts in lengthy, complex and legalistic documents does not serve to protect retail investors.

2. FAIR Canada encourages the CSA to adopt point-of-sale disclosure rules for non-redeemable investment funds.

2.1. FAIR Canada is pleased that, as part of the final stage of implementing the point of sale disclosure proposals, the CSA "will consider point of sale disclosure requirements for other types of publicly offered investment funds, not just open-end mutual funds." Point of sale disclosure is an important feature in helping to protect investment fund investors and the extension of such disclosure to other types of funds will further the interests of investor protection. FAIR Canada cautions that implementation of point of sale disclosure to open-end mutual funds should not be delayed while consideration is given to extending it to other types of publicly offered investment funds.

2.2. FAIR Canada encourages specific point-of-sale disclosure requirements for non-redeemable funds that clearly disclose (1) the investments made by the fund; (2) any investment strategy (including leverage or borrowing) employed by the fund; and/or (3) any investments contemplated by the fund that would not be permitted under NI 81-102 for an open-end mutual fund or exchange-traded mutual fund. We discuss this proposal in more detail starting at section 5.14.

3. FAIR Canada reiterates its representations from our Phase 1 comments regarding the regulatory regime for closed-end funds.

3.1. In our response to the request for comments on the Phase 1 Proposals, FAIR Canada made two points regarding closed-end funds that we will reiterate here given that the Phase 2 Proposals deal primarily with such funds.[1] FAIR made these points regarding exchange-traded funds specifically, but we consider them to be generally applicable across the spectrum of closed-end funds.

3.2. First, we consider it unwise for the CSA to adopt (as it proposed to do in Phase 1) a blanket rule exempting closed-end funds from rules preventing the reimbursement of the costs of organization. We agree that later investors (whose prices will be determined on the basis of NAV, which does not include the costs of organization) should not benefit at the expense of the initial investors in mutual funds (who will, under this proposal, reimburse the organization costs when they purchase the fund). Since closed-end funds are permitted to make secondary offerings, the same price discrimination issues apply as for open-end mutual funds, even though they would not apply between investors in the primary offering. Therefore unless closed-end funds are prevented from making secondary offerings, price discrimination issues continue to exist and reimbursement by the fund (that is, the initial unitholders) should not be permitted.

3.3. Second, we continue to urge the CSA to combat the gradual trend within the investment fund industry to make redemption options (where they are available) less and less attractive to investors. As such, we continue to advocate a strict lower bound of 95% of net asset value (NAV) early redemption option as the lowest allowable fraction of NAV at which closed-end funds will be permitted to redeem units, when a redemption feature is part of the fund. Closed-end fund investors often face thin markets for selling their units. In the event of market difficulties, markets could become very thin. We urge the CSA not to consider the redemption option for investors to be a nuisance to be minimized or done away with in

[1] FAIR Canada, RE: Comments on CSA's Proposed Amendments to NI 81-102 *Mutual Funds* and NI 81-106 *Investment Fund Continuous Disclosure*, and Related Consequential Amendments (September 24, 2010), online: <http://faircanada.ca/wp-content/uploads/2008/12/Mutual-funds-RFC-100924-Final-Sign.pdf>.

preference to market sales, but instead as protection for investors, which investors should be entitled to access in a non-punitive way.

4. FAIR Canada agrees that CSA's proposed specific protections for investors in non-redeemable funds are appropriate and will enhance investor protection.

4.1. FAIR Canada agrees with the CSA's suggestion in the Notice that core restrictions and operational requirements be placed on non-redeemable investment funds. The CSA proposes to do this through a stand-alone rule for non-redeemable funds. We discuss the disadvantages of an entirely free-standing rule in sections 5.2 to 5.4, and in the following sections we will discuss the particular proposals CSA has advanced for operational rules.

Conflict of Interest and Self-Dealing

4.2. The CSA proposes to put in place conflicts of interest rules that will prevent self-dealing and investment in related persons or companies. We think this is entirely appropriate. There can be no sound business purpose in favour of self-dealing or a related-party investment that is not trumped by the investor protection aspect of such requirements, which are normally considered basic to collective investment regulation.

4.3. Modern financial groups are hugely diverse entities that undertake a vast array of financial services, and can arrange billing and fees in the interest of the larger group, rather than any individual unit. As a result, there are limitless opportunities for such groups to provide related-party services at prices that may not reflect an arm's-length bargain. Given this, regulation relating to conflicts of interest and self-dealing should specify broad categories of prohibited transactions with relief being provided on a tightly controlled exemption basis. FAIR Canada considers Part 4 of NI 81-102 to be a useful model for such a rule, with the exception of the exemptions provided by approval of an Independent Review Committee ("IRC") (see sections 4.4 and 4.5 below).

4.4. The CSA proposes to use the IRC model from NI 81-107 to regulate exemptions to the conflicts of interest and self-dealing rules. FAIR Canada has a number of concerns with the IRC model, in particular its weak governance structure.

4.5. Fund managers, not unitholders, have the power to choose members of the fund's IRC. Unitholders are not consulted, as a rule, and the governance structure (and the IRC's role within it) is not transparent to the typical investor. IRCs are regulatory capture writ large: the wholesale handover of regulatory oversight functions to small handpicked groups who are typically friendly with fund managers and set their own compensation. FAIR Canada considers IRCs to represent a weaker level of professional regulatory ability than that of the securities regulators themselves, which means that investor protection is compromised. FAIR Canada continues to be skeptical that IRCs are an appropriate vehicle for managing conflicts of interest of fund managers. The IRCs have worked to the advantage of large fund companies who can benefit from related party transactions and inter-fund trading but not the investors on whose behalf the IRCs were implemented.

4.6. The IRC model relies on managers to identify conflicts situations (or potential conflicts situations) and IRCs have no power to independently investigate potential conflicts. This is a fundamental weakness of the IRCs as a model for fund governance. FAIR Canada notes the OSC's Focussed Disclosure Review on IRCs[2] which indicated a particularly disturbing trend of IRCs giving "standing instructions" to fund managers for managing conflicts of interest, without engaging a subsequent review of transactions subject to standing instructions. This is not, in any meaningful sense, effective governance.

[2] Published as OSC Staff Notice 81-713, March 25, 2011.

4.7. FAIR Canada is concerned that the IRC model does not achieve its intended purpose of proper fund governance for the benefit of investors. FAIR Canada recommends that the CSA reconsider the IRC model across the spectrum of publicly offered investment funds. FAIR Canada also encourages the CSA to put in place an equivalent to section 4.3 of NI 81-102 restricting liability and indemnification provisions in contracts with service providers. We consider this to be a basic investor protection measure; placing investors at risk for the negligence of service providers cannot be in their best interests under any circumstances.

Securityholder and Regulatory Approval Requirements

4.8. FAIR Canada considers Part 5 of NI 81-102 to be an ideal model for a securityholder approval mechanism for major, fundamental transactions. We agree with the CSA's suggestion that it be adopted for use by non-redeemable funds.

4.9. Voting rights for fund investors is a key element not only of investor protection but as a check and balance on fund governance in significant transactions. FAIR Canada notes that unitholder voting rights have been linked with investor-oriented governance decisions.[3]

4.10. Of particular importance in Part 5 of NI 81-102 is the requirement that none of the investment funds participating in any merger, acquisition or amalgamation event shall bear any of the costs associated with such a transaction.

4.11. However, FAIR Canada questions whether any exemption similar to subsection 5.5(2) of NI 81-102 is necessary. Approvals of the transactions covered by this subsection would be routine, but such transactions (especially those which are borderline cases) would be improved and assisted by the provision of review by the regulatory authorities. All fundamental transactions of this nature can benefit by being reviewed. Such exemptions could also be processed speedily. As matters currently stand, a merger, amalgamation or transfer of assets can be made without oversight. The benefit of this lack of consideration by regulators should be questioned, not only for non-redeemable funds but for investment funds generally.

Custodianship Requirements

4.12. FAIR Canada agrees that if a stand-alone rule governing the operation of non-redeemable investment funds is adopted, then custodianship requirements should be included in that rule.

4.13. FAIR Canada recommends the harmonization of custodianship requirements between open-end mutual funds and non-redeemable investment funds. FAIR Canada considers the provisions of Part 14 of NI 41-101 and of Part 6 of NI 81-102 to be essentially equivalent but care should be taken to harmonize them in the creation of any stand-alone rule.

Sales Communications and Prohibited Representations

4.14. FAIR Canada encourages the CSA to consider the adoption of the equivalent of Part 15 of NI 81-102 in any stand-alone rule for non-redeemable investment funds. Because most sales of non-redeemable investment funds are made through the secondary market, the application of such a rule would ordinarily be fairly limited; however, it will assist in controlling the fund-related information emerging from the

[3] In the Canadian context, see Mark Gillen, "A comparison of business income trust governance and corporate governance: is there a need for legislation or further regulation?" McGill Law Journal, June 2006, which deals with business income trusts that often have similar governance structures. More generally, see A. Joseph Warburton, "Should Mutual Funds Be Corporations? A Legal & Econometric Analysis" 33 Iowa J. Corp. L. 745 (2008) which advocates voting rights for investors as a key positive feature of US mutual funds rules requiring corporate structures.

funds themselves. FAIR Canada considers the careful regulation of sales communications to be a key value in promoting investor confidence and investor protection.

5. FAIR Canada's Responses to Issues for Comment

❖ ***Question 1*** *- Do you agree with our view that certain consistent, core investor protection requirements should apply equally to all types of publicly offered investment funds? We particularly seek feedback from investors.*

5.1. Consistency of approach is valuable in investment regulation generally. FAIR Canada supports making certain core investor protection requirements uniform across the universe of publicly offered investment funds, with the proviso that for certain types of funds (particularly complex and/or structured investment products) there should be specific, stricter rules designed to ensure that unsuitable products are not sold or made available to investors.

5.2. Retail investors are often unaware of the nuances between different types of investment funds and their associated regulatory protections. It is essential that all funds available to retail investors have basic investor protection requirements. Proposed regulatory requirements should be drafted to ensure they cover existing as well as future product types.

❖ ***Question 2*** *-Do you agree with our approach to develop a stand-alone operational rule for non-redeemable investment funds? If not, what approach would you propose? What are the advantages and disadvantages of this approach?*

5.3. FAIR Canada would prefer for there to be a universal operational rule applying to all investment funds, from which certain specific rules for non-redeemable investment funds would be supplemented in order to ensure that there is an ongoing consistency of approach in investment regulation and to prevent regulatory arbitrage by issuers. This supplemental rule would indeed be a stand-alone rule.

5.4. If a basic, universal operational rule is not implemented, FAIR Canada recommends that the various stand-alone rules should be made as robust as possible in order to prevent situations where investment funds escape each of the stand-alone rules.

5.5. A larger number of stand-alone rules, rather than a single "trunk" of basic operational rules to which fund-specific rules are grafted, allows for a greater potential for funds or products to slip through the cracks, falling between the stand-alone rules and escaping necessary regulation.

❖ ***Question 3*** *- We seek feedback on the initial restrictions and operational requirements we have identified for non-redeemable investment funds. If you disagree, what restrictions and operational requirements would be appropriate for nonredeemable investment funds and why? If you think no requirements are needed, please explain why.*

5.6. We have considered this question in sections 4.1 to 4.12.

❖ ***Question 4*** *- Are there other investor protection principles and/or requirements of NI 81-102 which the CSA should consider for nonredeemable investment funds at this time? If so, please explain.*

5.7. We have considered this question in section 4.13.

❖ ***Question 5*** *- In addition to the initial requirements the CSA has identified for non-redeemable investment funds, we are considering the possibility of imposing certain investment restrictions, similar to those set out under Part 2 of NI 81-102. Please identify those*

core investment restrictions that, in your view, should apply to these funds and explain why. If you think no investment restrictions are needed, please explain why.

5.8. FAIR Canada views the distinction between closed-end funds and open-end mutual funds to be beneficial to investors and would not support the elimination of the distinction between open-end and closed-end, non-redeemable funds in terms of investment restrictions. We believe that the distinction is important because these separate classifications assist retail investors in differentiating between the categories of investments. If the categories were collapsed, retail investors would be even less able to distinguish between these fundamentally different types of investments.

5.9. FAIR Canada continues to be concerned about the tiering of managed funds, a procedure that we view to be inappropriate for collective investment mechanisms, outside the possibility of using managed money market funds as a short term provider of liquidity.

5.10. In our view, tiered investment fund structures are generally antithetical to the concept of an investment fund, in which a fund manager is engaged to invest the fund's assets according to that manager's best skill and ability, in line with the investment objectives of the fund. Tiered funds, particularly when the bottom-level funds are managed funds, instead result in fund managers investing in each other's products. What is almost inevitably tiered in such arrangements is not profit, but fees, eating into investors' returns. It makes little sense for expert investors to replace the judgements of others for their own, yet the tiering of mutual funds accomplishes little else. Management fees, loads, commissions and other expenses are incurred at both levels, with no additional benefit for the ultimate investor.

5.11. FAIR Canada does consider some "investment funds", such as index participation units or other static, low-fee funds, to be appropriate investment vehicles for investment funds. Similarly, we consider money market funds to be an appropriate investment where such investments are used to park cash or provide liquidity.

5.12. FAIR Canada would therefore support the extension of any anti-tiering rules that are brought in as part of the Phase 1 proposals to non-redeemable investment funds. FAIR Canada also continues to encourage the adoption of anti-tiering rules as part of the Phase 1 proposals for open-end mutual funds.

5.13. FAIR Canada recommends that the CSA consider the adoption of clear rules regarding the disclosure of the investment strategies and types of investments made by closed-end, non-redeemable investment funds as part of the proposed point-of-sale disclosure as well as a continuous disclosure obligation.

5.14. Essentially, the FAIR Canada's suggested rules would require a non-redeemable investment fund to disclose, in its point-of-sale disclosure materials or on a continuous basis, any deviation from the current investment restrictions of NI 81-102 for open-end mutual funds. The disclosure would need to be made in plain English and would also form part of the simplified "Fund Facts" documentation, if Fund Facts documentation is adopted as part of the point-of-sale disclosure rules. The disclosure would identify which elements of NI 81-102 the fund does not propose to follow, would identify any actual investments that do not comply with NI 81-102 restrictions, and would assess the resulting impact to the risk profile of the investment fund. The disclosure would also include a clear and plain statement that other investment funds exist which adhere to the NI 81-102 investment restrictions more closely.

5.15. The aim of such a rule would be to make clear to investors, particularly retail investors, the fundamentally different risk profile of an investment fund that complies with the NI 81-102 restrictions, versus one that does not.

❖ ***Question 6*** *- What do you foresee as the anticipated cost burdens in complying with the initial restrictions and operational requirements we are proposing for non-redeemable investment funds? Specifically, we request data from the investment fund*

industry and service providers on the anticipated costs of complying with the Phase 2 proposals.

5.16. FAIR Canada is unable to make such an assessment beyond noting that there would likely not be cost burdens that could be considered significant or harmful to the market given that: (i) open-end mutual funds hold a large portion of the investment fund market, and (ii) the requirements proposed are no more onerous than those placed on open-end investment funds.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-572-2282/ ermanno.pascutto@faircanada.ca or Marian Passmore at 416-572-2728/ marian.passmore@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights

cc: British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut