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Canadian Securities Regulators Adopt New Rules on Fund Governance in Canada

 [20237] August 1, 2006 TO: INTERNATIONAL MEMBERS No. 16-06 INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 21-06 RE: CANADIAN SECURITIES REGULATORS ADOPT NEW RULES ON FUND GOVERNANCE IN CANADA Last Friday, the Canadian Securities Administrators (CSA)1 released National Instrument 81- 107, which will require all investment funds that are reporting issuers in Canada to establish an Independent Review Committee (IRC) to oversee all decisions involving conflicts of interest faced by the fund's manager.2 NI 81-107 is particularly noteworthy as the latest and most significant step in more than seven years of work on a new regulatory framework for fund governance in Canada. Background In 1999, the CSA retained Stephen Erlichman to summarize the debate over fund governance in Canada and to make specific recommendations on possible improvements. His report was released in June, 2000.3 In March 2002, the CSA released a concept proposal based on the Erlichman report that set out a system of fund governance with a board-like body that would oversee all of the fund manager's activities. The CSA followed that consultation with a January 2004 proposal for a national instrument on fund governance. Notably, the 2004 proposal limited the role of the governance body (now called the IRC) to the oversight of potential conflicts of interest, substantially carving back the broad oversight role described in the 2002 concept release. The CSA reproposed the national instrument in May 2005, strengthening the role of the IRC in response to comments that it should have more "teeth." The final adoption of NI 81-107 is a result of the public consultation on the May 2005 proposal. 1 The CSA is comprised of the thirteen provincial and territorial securities regulators in Canada. 2 NI 81-107, "Independent Review Committee for Investment Funds," (July 28, 2006) , available at http://www.osc.gov.on.ca/Regulation/Rulemaking/Current/Part8/rule_20060728_81-107_independentreview.pdf, or http://members.ici.org/getPublicPDF.do?file=20237link 3 Stephen Erlichman, "Making it Mutual: Aligning the Interests of Investors and Managers: Recommendations for a Mutual Fund Governance Regime in Canada" (June, 2000). 2 The IRC NI 81-107 requires all investment funds that are reporting issuers to establish an IRC to oversee all decisions involving conflicts of interest faced by a fund manager. An IRC must have at least three members, each of whom is independent from the manager. The role of the IRC, depending on the nature of the conflict, will be to either approve a fund manager's decision or provide recommendations before the manager may proceed. NI 81-107 covers two types of conflicts: (i) "business" or "operational" conflicts - those relating to the

operation by the manager of its funds that are not specifically regulated under securities legislation, except through the general duties of loyalty and care imposed on the fund manager; and (ii) “structural” conflicts – those conflicts resulting from proposed transactions by the manager with related entities of the manager, fund or portfolio manager currently prohibited or restricted by securities legislation. Structural conflicts and certain other enumerated transactions, such as the change of the fund’s auditor, must be approved by the IRC before the transaction may proceed. For other conflicts of interest, the IRC must provide the fund manager with a recommendation, which the fund manager must consider before proceeding. Although NI 81-107 requires each fund to have an IRC, it is flexible with respect to the actual structure employed by fund managers. In the commentary accompanying the rule, the CSA explains that: Each manager is expected to establish an IRC using a structure that is appropriate for the investment funds it manages, having regard to the expected workload of that committee. For example, a manager may establish one IRC for each of the investment funds it manages, for several of its investment funds, or for all of its investment funds. . . . [NI 81-107] does not prevent investment funds from sharing an IRC with investment funds managed by another manager [nor does it] prevent a third party from offering IRCs for investment funds. Managers of smaller families of investment funds may find these to be cost-effective ways to establish IRCs for their investment funds.4 NI 81-107 also requires that the fund manager establish written policies and procedures governing the review of conflicts of interest and the referral of matters to the IRC. Next Procedural Steps; Effective Date Although each of the 13 provincial and territorial securities regulators in Canada are represented at the CSA, securities regulation in Canada remains provincial and “national instruments” 4 See commentary accompanying Section 3.1. 3 adopted by the CSA are not, in and of themselves, binding law. Each province or territory must act to approve the national instrument as a local rule or policy and may, in the course of that approval process, amend the national instrument. Provided that all necessary provincial and territorial approvals are obtained, NI 81-107 will come into force on November 1, 2006, with a one-year transition period for full compliance. Robert C. Grohowski Senior Counsel - International Affairs

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