

# Proposed National Instrument 81-107

## Independent Review Committee for Mutual Funds

### Note to reader

This Instrument will be a National Instrument. It will contain both legally binding rules and guidance on the application of those rules.

### Table of Contents

#### Part 1 Definitions and Application

- 1.1 Definitions
- 1.2 Mutual funds subject to Instrument
- 1.3 Multiple class mutual funds

#### Part 2 Independent Review Committee

- 2.1 Independent review committee for mutual funds
- 2.2 Initial appointment
- 2.3 Composition, term of office and vacancies
- 2.4 Independence
- 2.5 Responsibilities
- 2.6 Standard of care
- 2.7 Authority
- 2.8 Liability
- 2.9 Proceedings
- 2.10 Ceasing to be a member
- 2.11 Disclosure

#### Part 3 Matters referred to the independent review committee

- 3.1 Conflicts of interest
- 3.2 Changes to the mutual fund
- 3.3 Inter-fund trades
- 3.4 Supporting Information

#### Part 4 Exemptions

- 4.1 Exemption
- 4.2 Revocations of exemptions, waivers or approvals

#### Part 5 Effective Date

- 5.1 Effective date

## Introduction

*This National Instrument (the Instrument) is designed to promote investor protection in mutual funds while fostering market efficiency. It requires all publicly offered mutual funds to have an independent committee charged with reviewing any conflicts of interest that may arise out of the management of the funds and making recommendations to the manager as to how these conflicts may be fairly resolved.*

*This Instrument contains both rules and commentary on those rules. Each securities administrator in Canada has made the rules contained here under authority granted by the securities legislation of the applicable jurisdiction. The rules have the force of law in each province and territory of Canada.*

*Each securities administrator has also adopted the commentary on the rules as policies. Commentary may explain the implications of a rule, offer examples or indicate different ways to comply with a rule. It may expand on a particular subject without being exhaustive. Commentary is not legally binding, but it does reflect the views of the Canadian securities regulatory authorities. Commentary is labelled as such and it always appears in italic type.*

## **Part 1 Definitions and Application**

### **1.1 Definitions**

Terms defined elsewhere in securities regulation have the meaning ascribed to them in those instruments.

#### *Commentary*

1. *Terms used in this Instrument should be given their ordinary meaning, unless they are defined elsewhere in securities regulation (in local or national definition rules or in securities legislation).*

### **1.2 Mutual funds subject to Instrument**

- (1) This Instrument applies only to a mutual fund that is a reporting issuer in the local jurisdiction.
- (2) This Instrument does not apply to a mutual fund that is
  - (a) a labour-sponsored fund;
  - (b) listed and posted for trading on a stock exchange or quoted on an over-the-counter market; or

- (c) not governed by National Instrument 81-102 *Mutual Funds*.

### *Commentary*

1. *The terms “investment fund” and “mutual fund” are defined in securities legislation. The term “labour-sponsored fund” is defined in proposed National Instrument 81-106 Investment Fund Continuous Disclosure.*
2. *This Instrument applies only to specific publicly offered mutual funds. Those mutual funds are investment funds that*
  - (a) *an investor would reasonably understand as being conventional mutual funds; and*
  - (b) *a dealer or a representative licensed to sell mutual funds is qualified to sell.*
3. *This Instrument does not regulate*
  - (a) *investment funds that are not mutual funds;*
  - (b) *mutual funds (commonly referred to as pooled funds) that sell securities to the public only under capital raising exemptions permitted by securities legislation (and, therefore, are not reporting issuers); and*
  - (c) *investment funds that may strictly fall within the definition of “mutual fund” in securities legislation, but that are specifically excluded from the scope of this Instrument under section 1.2(2), because they are not structured like conventional mutual funds.*

#### **Issues for Comment**

01. Do you think this Instrument should apply either more broadly or more narrowly? If so, please explain why and in what matter.

### **1.3 Multiple class mutual funds**

For multiple class mutual funds, each class or series should be considered a separate mutual fund if the class or series has a fundamental investment objective that is different from the fundamental investment objectives of the other classes or series.

### *Commentary*

1. *Some mutual funds have multiple classes or series of securities, with each invested according to a separate fundamental investment objective. The assets of multiple class mutual funds are notionally divided into separate portfolios of assets, with each portfolio referable to a specific class or series of the mutual fund. These multiple class mutual funds are distinguishable from those mutual funds which are divided into different classes (for purposes of distinguishing different fee and service structures,*

*for example), but where the assets of those funds are invested according to a common fundamental investment objective.*

## **Part 2 Independent Review Committee**

### **2.1 Independent review committee for a mutual fund**

A mutual fund must have an independent review committee in accordance with this Part.

#### *Commentary*

1. *A manager should establish an independent review committee using a structure that works for the mutual funds it manages, having regard to the potential work-load of that committee. For example, a manager that manages more than one mutual fund may establish one independent review committee for all of the mutual funds it manages. Alternatively, the manager may establish an independent review committee for each of its mutual funds, or groups of its mutual funds.*
2. *This Instrument does not mandate a specific legal structure for an independent review committee, provided a manager complies with the minimum requirements set out in this Part when creating the committee. A manager may use any of the following for the independent review committee for its mutual funds:*
  - *individuals appointed as trustees for the mutual funds;*
  - *the board of directors, or a special committee of the board of directors, of a registered trust company that acts as trustee for the mutual funds; and*
  - *a committee of individuals, each of whom is independent from the manager.*

*The board of directors, or a special committee of the board of directors, of the manager or of an entity related to the manager cannot act as the independent review committee since those directors will have a material relationship with the manager and, therefore, not be independent.*

*The manager of a corporate mutual fund may use the mutual fund's board of directors as the independent review committee if it meets the other requirements of this Part. Alternatively, it could establish a separate committee as the independent review committee to act independently from the board of directors of the mutual fund.*

*This Instrument does not prevent mutual funds from sharing an independent review committee with another fund manager. Managers of*

*smaller families of mutual funds may find this a cost-effective way to set up independent review committees for their mutual funds.*

3. *The Canadian securities regulatory authorities recommend that a manager consider whether the constating documents for a mutual fund (the declaration of trust or the articles of incorporation) need to be amended to create the independent review committee. Managers must adhere to the amendment procedures imposed in those documents.*

## **2.2 Initial appointment**

- (1) The manager must appoint the first members of the independent review committee.
- (2) The appointments made pursuant to subsection (1) must occur
  - (a) before any purchase orders for the mutual fund are accepted, for a mutual fund that is established after the first anniversary of the date this Instrument comes into force; or
  - (b) by the first anniversary of the date this Instrument comes into force, for a mutual fund other than a mutual fund described in paragraph (a).

## **2.3 Composition, Term of office and vacancies**

- (1) An independent review committee must have at least three members.
- (2) The term of office of a member of an independent review committee must be not less than 2 years and not more than 5 years.
- (3) Except as provided in subsection (4), the remaining members of the independent review committee must forthwith appoint replacement members to fill any vacancies on the independent review committee.
- (4) If all members of an independent review committee cease to be members at the same time because of the operation of subsection 2.10(1) or paragraph 2.10(2)(b), the manager must forthwith appoint replacement members.

### *Commentary*

1. *The manager will appoint the first members of an independent review committee and, if all members cease to be members at once, the manager will also appoint the replacement members. The Canadian securities regulatory authorities expect that the circumstances contemplated in subsection 2.3(4) will rarely occur—generally only in the event of a mass resignation by all the members of an independent review committee or a*

*change of manager or change in control of the manager. In those circumstances, managers should consider their timely disclosure obligations under securities legislation. A manager should contact the securities regulatory authority in its principal jurisdiction to notify them of a mass resignation of the members of the independent review committee and the reasons for such resignation.*

2. *Although the manager may assist the independent review committee in recruiting nominees or recommending nominees to fill vacancies on the committee, except in circumstances where subsection 2.3(4) applies, the independent review committee will ultimately decide. The Canadian securities regulatory authorities consider this consistent with good governance practices.*
3. *All members of an independent review committee should be appointed with staggered terms. Staggered terms are important because they ensure continuity and continued independence from the manager. This Instrument does not prohibit the independent review committee from reappointing members or limit the number of terms that a member may serve.*
4. *A manager should consider the workload of the independent review committee in assessing the appropriate number of members of the committee to ensure the effectiveness of the committee.*

**Note to reader**

- Section 2.3 provides a transition period of one year from the coming into force of this Instrument that gives managers time to set up independent review committees for their mutual funds. After the first anniversary date, a manager must establish an independent review committee for any new mutual fund before offering securities of the mutual fund to the public.

## **2.4 Independence**

- (1) Every independent review committee member must be independent.
- (2) A member of the independent review committee is not independent if the member has a direct or indirect material relationship with the manager, the mutual fund, or an entity related to the manager.
- (3) For the purposes of subsection (2), a material relationship is any relationship that a reasonable person would consider might interfere with the exercise of the member's independent judgement regarding conflicts of interest facing the manager.
- (4) For the purposes of this section, a person who is, or has been, a director of a registered trust company that acts as trustee for a mutual fund, will be

independent, if he or she is, or was, considered an independent director of the registered trust company for the purposes of the governing regulation of the registered trust company and does not or did not otherwise have a material relationship with the manager or the mutual fund.

### *Commentary*

1. *All members of the independent review committee must be independent from the manager, the mutual fund and entities related to the manager because one of the principal functions of the independent review committee is to review the manager's conflicts of interest. The phrase "an entity related to the manager" is defined for the purposes of this Instrument in subsection 3.1(3).*

2. *The directors or a special committee of the board of directors of the manager or of an entity related to the manager cannot act as the independent review committee since those directors will be considered to have a material relationship with the manager.*

*The members of the independent review committee should not themselves be subject to inherent conflicts or divided loyalties. The Canadian securities regulatory authorities recognize, however, that there may be inherent conflicts relating to inter-fund issues where a single independent review committee acts for a family of mutual funds. In such cases, the committee's recommendation must comply with subsection 2.5(1) for each fund.*

3. *A direct or indirect material relationship referred to in subsection 2.4(2) may include ownership, commercial, charitable, industrial, banking, consulting, legal, accounting or familial relationships. However, only those relationships, which might, in the view of a reasonable person, interfere with the exercise of a member's independent judgement, should be considered material relationships within the meaning of section 2.4.*

4. *The Canadian securities regulatory authorities believe that the following persons will in most circumstances be considered to have a relationship with the manager, the mutual fund or an entity related to the manager that might reasonably interfere with the exercise of the person's independent judgement. Consequently, these persons would not be considered to be independent for the purposes of this Instrument and could not be members of an independent review committee of the mutual fund*

- *a person who is, or whose immediate family member is, or at any time during the previous 3 years has been, an officer, director or employee of the manager, the mutual fund or an entity related to the manager;*
- *a person who has accepted, directly or indirectly, at any time during the past 3 years, any consulting, advisory or other compensatory fee*

*from the manager, the mutual fund or an entity related to the manager; and*

- *a person who is an associate of any person referred to above.*

*The indirect acceptance by a person of any consulting, advisory or other compensatory fee includes acceptance of a fee by:*

- *an immediate family member of that person; or*
- *an entity that provides accounting, consulting, legal, investment banking, portfolio management, back office services or financial advisory services to the manager or the mutual fund or any company related to the manager, in which the person is a partner, member or executive officer of, or person who occupies a similar position but not an entity in which such person is a limited partner, non-managing member or person occupying a similar position who, in each case, has no active role in providing services to the entity.*

*Managers should consider the nature of the relationships outlined above when applying the general independence test set out in subsections 2.4(2) and (3) to other relationships. .*

5. *In subsection 2.4(4), the Canadian securities regulatory authorities recognize that the independent members of the board of a registered trust company that acts as trustee of a mutual fund are sufficiently independent from the manager and the mutual fund to properly carry out the role of the independent review committee, due to the regulation of registered trust companies and their responsibilities at law as trustees.*
6. *The Canadian securities regulatory authorities expect the independent review committee will have in place policies that describe how members should conduct themselves when they are conflicted in relation to a matter the manager has referred to the committee.*

#### **Note to reader**

- Section 2.4 requires that all of the members of the independent review committee be independent from the manager and the mutual fund. Commentary 4 parallels proposed Multilateral Instrument 52-110 *Audit Committees*, but is tailored to mutual funds. We will change Commentary 4 to conform to the requirements in force when the CSA finalize this Instrument.

Subsection 2.4(4) builds in an exemption for registered trust companies that act as trustees for mutual funds and that are entities related to the manager of those mutual funds.





### Issues for Comment

02. Do you agree with a 'principles' based definition of independence? Are there alternatives?
03. Do you consider the definition of independence in subsections 2.4(2) and (3) appropriate?
04. Commentary 4 describes certain categories of persons we consider to have a material relationship with the manager or the mutual fund. Do you agree with the categories of precluded persons? Are there other categories that should be added?
05. Is the 'cooling off' period in Commentary 4 an appropriate period? Too long? Too short?

## 2.5 Responsibilities

- (1) The independent review committee must consider and provide impartial judgement on a matter referred to it by the manager and recommend to the manager what action the manager should take to achieve a fair and reasonable result for the mutual fund.
- (2) The independent review committee must deliberate on and decide on a recommendation to the manager in the absence of any representative of the manager or any entity related to the manager.
- (3) Within six months of its formation, the independent review committee must adopt a written charter that sets out its mandate and responsibilities.

### *Commentary*

1. *The role of the independent review committee is to provide impartial judgement and make recommendations to the manager of the mutual fund about matters where the manager's interests conflict with the interests of the mutual fund.*

*The Canadian securities regulatory authorities expect the written charter to identify categories of matters that the manager should refer to the independent review committee for its consideration. The independent review committee should consider the specific conflicts to which the manager is subject when developing the written charter. The independent review committee and the manager are expected to review periodically this charter to ensure that they are both complying with this Instrument.*

2. *Subsection 2.5(2) does not preclude the independent review committee from receiving oral or written submissions from the manager.*
3. *The manager and the independent review committee may mutually agree that the independent review committee should have a broader mandate. For example, the independent review committee may monitor the*

*administration and management of the mutual funds or give general advice to the manager. This Instrument does not regulate those arrangements.*

## **2.6 Standard of care**

- (1) When carrying out his or her functions, a member of a mutual fund's independent review committee must
  - (a) act honestly and in good faith;
  - (b) act in the best interests of the mutual fund; and
  - (c) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.
- (2) A member of an independent review committee will not contravene his or her standard of care set out in subsection (1), if he or she exercises reasonable judgement based on the information available at the time he or she considers a matter referred to the committee.

### *Commentary*

1. *Section 2.6 recognizes the special relationship between the independent review committee and the mutual fund and therefore imposes a standard of care consistent with that relationship.*
2. *For the purposes of this section, the Canadian securities regulatory authorities consider that a member has met his or her responsibility to act in the best interests of the mutual fund if the member makes his or her recommendation under subsection 2.5(1) with a view to what is a fair and reasonable result for the mutual fund without regard to the interests of the manager or any entity related to the manager. The standard of care for a member of an independent review committee is that of a reasonably prudent person.*

## **2.7 Authority**

- (1) An independent review committee must have authority to
  - (a) engage independent counsel and other advisors it determines necessary to carry out its duties;
  - (b) set and pay the compensation and proper expenses for any advisors employed by the independent review committee from the assets of the mutual fund; and

- (c) set and pay the compensation and proper expenses for the members of the independent review committee from the assets of the mutual fund.

### *Commentary*

1. *The manager may recommend the amount and type of compensation to be paid by a mutual fund to the members of the independent review committee . Consistent with good governance practices, the independent review committee will decide on its compensation considering the manager's recommendation, if any. The compensation should reflect what would be fair and reasonable for the mutual fund and the workload of the independent review committee.*
2. *The manager should not pay any compensation directly or indirectly (by reimbursing the mutual fund) to the independent review committee because this practice could jeopardize the independence of independent review committee members.*

## **2.8 Liability**

### *Commentary*

1. *The Canadian securities regulatory authorities believe the members of an independent review committee should be accountable for their actions. At the same time, we are not adverse to such liability being limited.*
2. *A mutual fund may indemnify or purchase insurance coverage for the members of the independent review committee, on reasonable commercial terms. The Canadian Securities regulatory authorities expect, however, that such insurance would not cover any liability resulting from members of the independent review committee not fulfilling their responsibilities and standard of care.*

#### **Note to Reader**

Although we received many submissions recommending that we limit the liability of members of the independent review committee for breaches of the standard of care, we currently do not have the regulatory authority to limit the liability of the independent review committee that may arise at common law. We will continue to monitor the Uniform Securities Legislation initiative, which may give us the authority to limit the liability of members of the independent review committee.

#### **Issues for Comment**

06. We were told that without a limit on the liability of members of the independent review committee, insurance coverage for the members would be difficult to obtain. What are your views, given the responsibilities the IRC will have under this Instrument?
07. Will potential members be deterred from sitting on the independent review committee without such a limitation?

## 2.9 Proceedings

An independent review committee must maintain a record of

- (a) its written charter;
- (b) minutes of its meetings; and
- (c) its reports and recommendations.

### *Commentary*

1. *Section 2.9 sets out the minimum requirements regarding the proceedings of an independent review committee. Subject to these requirements, the independent review committee may conduct its proceedings as it sees fit.*

## 2.10 Ceasing to be a member

- (1) An individual ceases to be a member of an independent review committee when
  - (a) the member dies or resigns;
  - (b) the member is removed in accordance with subsection (2);
  - (c) the member becomes disqualified under subsection (3);
  - (d) the member's term of office expires;
  - (e) the mutual fund terminates; or
  - (f) the manager of the mutual fund changes.
- (2) A member of an independent review committee can be removed from the committee by vote of a majority of
  - (a) the remaining members of the independent review committee; or
  - (b) the securityholders of the mutual fund at a special meeting called for that purpose by the manager.
- (3) A individual will cease to be a member of the independent review committee if he or she is
  - (a) no longer independent within the meaning of this Instrument;

- (b) of unsound mind and has been so found by a court in Canada or elsewhere; or
- (c) bankrupt.

### *Commentary*

1. *The Canadian securities regulatory authorities believe the manager should not have the power to remove a member of an independent review committee without obtaining the agreement of the remaining members of the committee or the approval of securityholders. Members of an independent review committee must be free to perform their functions in accordance with this Instrument without fear of being removed by the manager.*
2. *If a change of manager occurs, this Instrument provides that the term of office for all members of the mutual fund's independent review committee will end. The new manager (or the manager, under new controlling shareholders) must, under subsection 2.3(3) appoint new members of the independent review committee. These members may be the same members as previously appointed, provided these members continue to meet the independence requirements.*

## **2.11 Disclosure**

- (1) A mutual fund must disclose in its prospectus and in its periodic continuous disclosure reports
  - (a) the written charter of the independent review committee or an appropriate summary of the written charter; and
  - (b) the identity and experience of the independent review committee members.
- (2) For the relevant period, a mutual fund must disclose in each disclosure made under subsection (1)
  - (a) any changes in membership of the independent review committee;
  - (b) any instances where the manager did not follow a recommendation of the independent review committee, the general nature of the recommendation and the reasons for not following the recommendation; and

- (c) any report of the independent review committee that it directs the manager to incorporate into the prospectus or periodic continuous disclosure reports of the mutual fund.

### *Commentary*

1. *Section 2.11 sets out the minimum expectations regarding the disclosure to securityholders about the independent review committee. A manager should consider its obligations to make timely disclosure of any significant or material change in the mutual fund, particularly in the circumstances contemplated by paragraph 2.11(2)(b).*

#### **Notes to reader**

- This Instrument assumes that proposed NI 81-106 *Investment Fund Continuous Disclosure* is in force. In this Instrument, the word “prospectus” has been used to refer to disclosure in a point of sale document (today’s simplified prospectus and annual information form) and the phrase “periodic continuous disclosure reports” has been used to generically refer to the documents proposed by NI 81-106. We will change these references to conform to the disclosure requirements in force when the CSA finalize this Instrument.
- Section 2.11 and the commentary recognize that disclosure of any instances where the manager did not follow a recommendation of the independent review committee is a practical and realistic method of moderating disputes.

## **Part 3 Matters to be referred to the independent review committee**

### **3.1 Conflicts of interest**

- (1) If a reasonable person would question whether a manager has a conflict of interest in a matter related to its management of a mutual fund, the manager must refer the matter to the mutual fund’s independent review committee for its recommendation before taking any action in such matter.
- (2) In addition to any other conflict of interest that might be caught by the test in subsection (1), for the purposes of this Instrument, a manager is considered to have a “conflict of interest” where either
- (a) the manager; or
  - (b) an entity related to the manager
- has an interest in the matter that is different from, or conflicts with, the best interests of the mutual fund.
- (3) For the purposes of this Instrument, an entity is related to the manager, if it is

- (a) a person who can direct or cause the direction of the management and policies of the manager, whether through ownership of voting securities or otherwise, other than the independent review committee of the mutual fund; or
- (b) an affiliate, associate or a subsidiary of the manager or of a person referred to in paragraph (a).

### Commentary

1. *A manager can find itself in situations where its business and commercial interests conflict with its duty to act in the best interests of the mutual fund.*

*Section 3.1 recognizes that a manager may not be able to objectively determine whether it is acting in the best interests of the mutual fund when it is in a conflict of interest situation. This Instrument therefore requires that any situation in which a reasonable person would question whether the manager has a conflict of interest be referred by the manager to the independent review committee for a recommendation.*

*Subsection 3.1(2) sets out particular circumstances where the Canadian securities regulatory authorities believe a reasonable person would question whether the manager has a conflict of interest.*

2. *This Instrument does not list all the possible circumstances when a manager might experience a conflict between its own interests and the best interests of the mutual fund.*
3. *A manager may experience two different types of conflict situations—business conflicts and related party conflicts. These are described below. Not all managers will experience these conflicts and some may face conflicts that are not listed.*
4. *Business conflicts -- A manager may be making decisions that are motivated by its business interests rather than only the best interests of the mutual fund. These business conflicts would include situations where the manager may be motivated to favour one mutual fund over another mutual fund. Examples of situations when a manager might experience a conflict between its interests and its duty to act in the best interests of the mutual fund include:*
  - *Charging the mutual fund for the costs the manager has incurred in operating the mutual fund, in addition to charging the mutual fund a management fee;*
  - *Allocating securities among mutual funds in a fund family and among its non mutual fund clients;*



- *Allocating the costs incurred by the manager in operating mutual funds and carrying on its other portfolio management business, both among mutual funds in the fund family and among its non mutual fund clients;*
- *Correcting material errors made by the manager in administering or managing the mutual fund;*
- *Seeking best execution for the portfolios of the mutual funds and also for its non mutual fund clients;*
- *Charging the mutual fund a fee based on the manager's performance;*
- *Voting proxies or taking other corporate action on securities held by the mutual fund, when the manager has business relationships with the issuer of the securities;*
- *Marketing the mutual fund for sale through distributors, whether related to the manager or not, if the manager provides incentives to the distributors to sell the mutual fund and other mutual funds;*
- *Negotiating soft commissions with dealers with whom the manager places portfolio transactions for the mutual fund ;*
- *Making changes to the mutual fund (as contemplated by section 3.3);*
- *Favouring certain investors to obtain or maintain their investment in the mutual fund; and*
- *Bringing portfolio management of the mutual fund in house or to a party related to the manager if it was previously managed by a third party.*

5. *Related party conflicts -- A manager may contract for services or investments to be provided to the mutual fund by a person related to the manager. Examples of transactions with related parties include:*
- *The mutual fund purchases securities (whether debt or equity) issued by a company related to the manager;*
  - *The mutual fund invests in an issuer of which a director, officer or shareholder of the manager or of a related company is a director or officer, or in which any of such people has a material interest;*
  - *The mutual fund purchases or sells securities to or from a company related to the manager (principal trading);*
  - *Mutual funds within a fund family purchase and sell securities amongst themselves or with pooled funds that have the same manager (inter-fund trading);*
  - *The mutual fund purchases securities that are in primary distribution or within a short period of time after that, that have been underwritten by a dealer that is a company related to the manager;*
  - *Services are provided to the mutual fund by parties who are related to the manager; and*
  - *Portfolio transactions for the mutual fund are allocated to a dealer who is related to the manager.*

6. *When it first establishes the independent review committee, and periodically after that, a manager should consider all potentially applicable conflict situations contemplated by section 3.1 and discuss those situations with the independent review committee. This Instrument permits the manager and the independent review committee to decide how they will deal with each potential conflict situation in light of the particular circumstances that apply to the manager and the mutual fund. For example, the manager might suggest that the independent review committee*
  - (i) *review and comment on the manager's policies on conflicts of interest;*
  - (ii) *make recommendations in advance on the steps to be taken in specific conflict situations, including the mutual fund participating in transactions involving related parties; and/or*
  - (iii) *review periodic compliance reports from the manager on how it dealt with conflict situations.*

### **3.2 Changes to the mutual fund**

- (1) The manager must refer the following matters to a mutual fund's independent review committee for its recommendation before taking any action:
  1. a proposed change to the basis of the calculation of a fee or expense, or the introduction of a fee or expense, that is charged to the mutual fund or directly to its securityholders by the mutual fund or its manager in connection with the holdings of securities of the mutual fund, that could result in an increase in charges to the mutual fund or to its securityholders;
  2. a proposed change in the manager of the mutual fund, unless the new manager is an affiliate of the manager;
  3. a proposed change to the fundamental investment objectives of the mutual fund;
  4. a proposed change in the auditor of the mutual fund;
  5. a proposed decrease in the frequency of the calculation of the net asset value per security;
  6. a proposed reorganization of the mutual fund with, or transfer of its assets to, another mutual fund, if
    - (a) the mutual fund ceases to continue after the reorganization or transfer of assets; and
    - (b) the transaction results in the securityholders of the mutual fund

becoming securityholders in another mutual fund; or

7. a proposed reorganization of the mutual fund with, or acquisition of assets from, another mutual fund, if
  - (a) the mutual fund continues after the reorganization or acquisition of assets;
  - (b) the transaction results in the securityholders of the other mutual fund becoming securityholders in the mutual fund; and
  - (c) the transaction would be a significant change to the mutual fund.
- (2) Before proceeding with a change contemplated in paragraphs 1 and 3, the mutual fund must also
  - (a) obtain approval of its securityholders at a meeting called in accordance with National Instrument 81-102 *Mutual Funds*;
  - (b) include with the notice of meeting sent in accordance with National Instrument 81-102 *Mutual Funds* a summary of the recommendation of the independent review committee; and
  - (c) up to and including the effective date of the change, allow a securityholder to redeem securities of the mutual fund and purchase securities of another mutual fund managed by the manager without payment of any fee.
- (3) Before proceeding with a change contemplated in paragraphs 2,4,5,6 and 7, the mutual fund must also
  - (a) send a notice to all its securityholders at least 60 days before the effective date of the change that
    - (i) contains sufficient information about the change to enable a securityholder to make an informed decision about whether to continue to hold his or her securities of the mutual fund;
    - (ii) describes the free transfer right required by paragraph 3.2(3)(c); and
    - (iii) is filed with the securities regulatory authority or regulator concurrently with being sent to securityholders;
  - (b) include with the notice a summary of the recommendation of the independent review committee; and

- (c) up to and including the effective date of the change, allow a securityholder to redeem securities of that mutual fund and purchase securities of another mutual fund managed by the manager without payment of any fee.

### *Commentary*

1. *The Canadian securities regulatory authorities believe that the changes to the mutual fund set out in section 3.2 involve matters where a manager would have a conflict of interest. This Instrument requires the manager to refer any proposal to make any of these changes to the independent review committee. The independent review committee will review the proposed change to determine whether it is fair and reasonable to the mutual fund. Among other things, the independent review committee may recommend changes to the information being sent to securityholders or may recommend changes to the manager's proposal. The independent review committee may review the costs and expenses of carrying out the proposed change if the manager proposes that the mutual fund should bear these costs or expenses.*
2. *Section 3.2 does not override the constating documents of a mutual fund. A manager must follow any requirements set out in those documents, in addition to complying with this Instrument.*
3. *Section 3.2 does not replace the timely disclosure requirements set by securities regulation. A change to a mutual fund contemplated by section 3.2 may also constitute a significant or material change to the mutual fund. The obligations of a manager and a mutual fund to make timely disclosure of a significant or material change to the mutual fund are established in proposed National Instrument 81-106 Investment Fund Continuous Disclosure.*
4. *When a manager proposes to make a change to a mutual fund contemplated by section 3.2, the manager must give securityholders in that mutual fund a right to transfer, free of charge, to another mutual fund managed by that manager, without changes to any redemption fee schedule associated with their investment.*
5. *As well as any other information the manager of a mutual fund considers important, the manager should consider whether to include information about the following matters in the notice about a proposed change in order to meet the requirements of paragraph 3.2(3)(a):*
  - *the reasons for the proposed change;*
  - *why the manager believes the change is in the best interests of the mutual fund;*
  - *how the proposed change will affect the mutual fund and its securityholders;*

- *if applicable, the amount of any costs and expenses associated with the proposed change to be charged to the mutual fund and the reasons why the manager believes these costs and expenses are properly expenses of the mutual fund; and*
- *the alternatives available to security holders. These alternatives will include the right to switch to another mutual fund without charge and the right to redeem. If deferred sales charges or redemption fees will be charged to securityholders who opt to redeem (without transferring to another mutual fund managed by the manager), this fact and the applicable fees.*

#### **Notes to reader**

- For mutual funds subject to this Instrument, section 3.2 will replace the existing securityholder approval mechanism for the changes – specifically, the changes contemplated by paragraphs (b),(d),(e),(f) and (g) of section 5.1 of NI 81- 102 Mutual Funds.
- Notices must contain all relevant information and be written in plain language. All notices will be filed on SEDAR and therefore with the regulators.

#### **Issues for Comment**

08. We believe the changes to a mutual fund set out in section 3.3 involve conflicts of interest which can appropriately be referred to the independent review committee. Is this the right approach? Are there alternatives?
09. Does the right to transfer free of charge to another mutual fund managed by the same manager need to be mandated or is it industry practice?

### **3.3 Inter-fund Trades**

- (1) A mutual fund must not purchase or sell securities from or to a mutual fund managed by the same manager or from or to a pooled fund managed by the same manager (engage in inter-fund trades) unless the manager of the mutual fund refers the matter to the independent review committee for its recommendation and:
- (a) the transaction is a purchase or sale for which quotations for the bid and offer price of the security are readily available;
  - (b) the transaction is executed at the current market price of the security, which for the purposes of this paragraph is:
    1. if the security is an exchange-traded security or foreign exchange-traded security, the last sale price on the day of the transaction reported on the exchange upon which the security is listed or the quotation trade reporting system upon which the security is quoted, or, if there are no reported transactions for the day of the

transaction, the average of the highest current bid and lowest current offer for such security as displayed on the exchange or the quotation trade reporting system upon which the security is quoted; or

2. for all other securities, the average of the highest current bid and lowest current offer determined on the basis of reasonable inquiry;

(c) the transaction is subject to market integrity requirements, which for the purposes of this paragraph are

(i) if the security is exchange-traded,

1. the purchase or sale is printed through a member of an exchange or a user of the quotation and trade reporting system in accordance with the rules of the exchange or quotation and trade reporting system; and

2. the purchase or sale is subject to the market conduct and display requirements of the exchange, quotation and trade reporting system and securities regulatory authorities; or

(ii) if the security is foreign exchange-traded, the purchase or sale complies with the requirements that govern transparency and trading of foreign exchange-traded securities on the foreign exchange or foreign quotation and trade reporting system; or

(iii) for all other securities, the purchase is reported to a registered dealer, if the purchase or sale would otherwise have to be reported by a registered dealer under applicable securities laws; and

(d) the mutual fund must keep records of

(i) its policies and procedures to effect inter-fund trades;

(ii) each such purchase and sale of securities; and

(iii) the reports and recommendations of the manager to the independent review committee.

(2) An inter-fund trade made in accordance with the terms of subsection 3.3(1) is exempt from the provisions of National Instrument 21-101 *Marketplace Operation* and Section 6.1 and Part 8 of National Instrument 23-101 *Trading Rules*.

*Commentary*

1. *The terms “exchange-traded securities”, “foreign exchange-traded securities” and “member” are defined in National Instrument 21-101 Marketplace Operation. The term “pooled fund” is defined in proposed National Instrument 81-106 Investment Fund Continuous Disclosure.*
2. *This section is not intended to apply to securities issued by a mutual fund that are purchased by another fund within the same fund family.*
3. *This Instrument does not specify other policies and procedures that a manager and an independent review committee must follow to effect inter-fund trades. However, the Canadian securities regulatory authorities would usually expect such policies to include:*
  - *requirements that the inter-fund trade be consistent with, or necessary to meet, the investment objectives of the mutual fund;*
  - *requirements that no consideration other than cash payment against prompt delivery of a security and a printing fee will be paid between the mutual funds in connection with the transaction;*
  - *factors or criteria for allocating securities purchased for or sold by two or more funds managed by the manager;*
  - *requirements that the fund obtain at least one quote from an independent, arm’s-length purchaser or seller, immediately before the purchase or sale; and*
  - *requirements that periodic reviews of the inter-fund trades be conducted by the independent review committee.*
4. *Paragraph 3.3(1)(a) requires that the market quotations for the transactions be transparent, and that information be readily available from a newspaper or through a data vendor, for example.*
5. *Paragraph 3.3(1)(b) requires that the purchase price be not more than, or the sale price not less than, the price generally available for the same quantity of securities to other market participants in independent, arm’s-length transactions. The Canadian securities regulatory authorities expect that the terms of purchase or sale would be no less beneficial to the mutual fund than those generally available to other market participants in arm’s-length transactions.*
6. *Paragraph 3.3(1)(d) sets out the minimum expectations regarding the records a mutual fund must keep of its inter-fund trades. The Canadian securities regulatory authorities expect such records to be detailed, and sufficient to establish a good audit trail of the transactions. Accordingly, the records of each inter-fund transaction would likely include:*
  - *the securities purchased or sold;*
  - *the parties to the transaction;*
  - *the terms of the purchase or sale;*

- *the information or materials upon which the determination to purchase or sell was made;*
- *the closing price of the security (if applicable);*
- *the highest current independent bid and lowest current independent offer for such security on the day of the transaction (if there were no purchases or sales reported for such security on the day of the transaction); and*
- *full documentation of the reasons for any allocation to the mutual funds that departed from the stated allocation factors or criteria.*

**Note to reader**

This Instrument permits inter-fund trading of exchange-traded securities, benchmark government debt securities and certain corporate debt securities between mutual funds subject to this Instrument and between mutual funds managed by the same manager and pooled funds managed by the same manager. Section 3.3 is meant to address market transparency and market integrity concerns.

**Issues for Comment**

10. Do you agree with our proposals for inter-fund trading (in particular, the scope of the provisions?) If not, please explain.
11. Should clause 3.3(1)(b)(1) refer to “the last sale price” or should it enable managers to trade within the bid/offer spread during the trading day?
12. Is the pricing referred to in paragraph 3.3(1)(b) appropriate for illiquid exchange-traded and foreign exchange-traded securities, over-the-counter equity securities and debt securities?
13. Should the current market price of illiquid equity securities on an exchange be treated differently from over-the-counter equity securities?

**3.4 Supporting Information**

- (1) When a manager refers a matter to the independent review committee the manager must
  - (a) provide the independent review committee with information sufficient for the independent review committee to properly carry out its responsibilities, including
    - (i) a description of the facts and circumstances giving rise to the matter referred;
    - (ii) the manager’s proposed course or alternate courses of action in the matter; and



- (iii) all further information requested by the independent review committee;
- (b) make its senior officers who are knowledgeable about the matter available to attend meetings of the independent review committee as the committee may direct; and
- (c) if directed to do so by the independent review committee, send information about the matter to the securityholders of the mutual fund or convene a special meeting of the securityholders of the mutual fund to consider and vote on the matter.

### *Commentary*

1. *Subsection 3.4(1) requires the manager to give the independent review committee the information it needs to properly carry out its functions. In addition to providing written information, senior officers of the manager knowledgeable about the matter should be prepared to attend meetings of the independent review committee. Depending on the circumstance, it may be appropriate for the chief executive officer and the chief financial officer of the manager to attend meetings or provide information.*

*Subsection 3.4 (1)(c) recognizes that, in exceptional circumstances, an independent review committee may need a mechanism to contact securityholders of the mutual fund. An independent review committee should only require a manager to send information to securityholders or to convene a special meeting in unique circumstances, including when it has been unable to resolve a difference of opinion with the manager.*

## **Part 4 Exemptions**

### **4.1 Exemptions**

- (1) The regulator or securities regulatory authority may grant an exemption from this Instrument, in whole or in part, subject to such conditions or restrictions as may be imposed in the exemption.
- (2) Despite subsection (1), in Ontario only the regulator may grant such an exemption.

### **4.2 Revocation of exemptions, waivers or approvals**

- (1) A manager or a mutual fund that has obtained an exemption, waiver, or approval from a regulator or securities regulatory authority under a provision of securities regulation that was effective before this Instrument came into force, that deals

with the matters regulated by this Instrument, may no longer rely on the exemption, waiver or approval as of the date one year after this Instrument comes into force.

- (2) In British Columbia, subsection (1) does not apply.

*Commentary*

1. *The Canadian securities regulatory authorities are of the view that subsection 4.2(1) will effectively cause exemptions, waivers and approvals granted before this Instrument comes into force relating to matters dealt with by this Instrument, to expire one year after its coming into force.*

**Note to Reader**

Because of differences in legislation, in British Columbia, the securities regulatory authority expects to achieve the same result as this part, through a blanket order.

## **Part 5      Effective Date**

### **5.1      Effective date**

- (1) This Instrument comes into force on [    ].