

## STRUCTURED PRODUCTS BULLETIN

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### MANDATORY INDEPENDENT REVIEW COMMITTEES FOR INVESTMENT FUNDS: AN OVERVIEW

Investment fund governance in Canada will become more onerous beginning November 1, 2006 when *National Instrument 81-107 – Independent Review Committee for Investment Funds* (the “Rule”) comes into force. The Rule will require public investment funds to have an independent review committee (an “IRC”) whose role is to oversee all decisions involving an actual or perceived conflict of interest faced by a manager in the operation of a fund. Managers are encouraged to take steps now in order to comply with the Rule by the relevant deadlines.

#### Application of the Rule

The Rule requires every investment fund that is a reporting issuer to establish an IRC. This includes, in addition to conventional public mutual funds, labour-sponsored or venture-capital funds, scholarship plans, and closed-end funds listed and posted for trading on a stock exchange or quoted on an over-the-counter market. It will not apply to pooled funds that sell securities on a “private placement” basis only and thus are not reporting issuers.

#### Functions of an IRC

The primary functions of an IRC are to:

- consider and, if appropriate, approve proposals by the manager to make certain investments that are currently prohibited or restricted by securities legislation (structural conflict matters);
- consider and provide recommendations to the manager on all other conflict of interest matters that are referred to the IRC by the manager (operational conflict matters);
- conduct regular assessments of its effectiveness;
- report to the manager, securityholders and, in certain cases, the securities regulatory authorities; and
- maintain records of its charter, minutes of meetings, reports prepared and decisions made.

In addition, the approval of the IRC must be obtained prior to a change in a mutual fund’s auditor and certain reorganizations and transfers of assets between related mutual funds. The approval of the IRC will replace the current security holder approval requirement under Part 5 of *National Instrument 81-102 Mutual Funds* with respect to these matters.

Of note is the fact that if an IRC carries on any functions other than those prescribed by the Rule, those functions will not be regulated by the Rule.

#### Reviewing Conflicts of Interest

The Rule requires that, when a conflict of interest arises and before taking any action on the matter, the manager must determine what action it proposes to take and then refer the matter, along with its proposed action, to the IRC.

A “conflict of interest matter” means both matters that are currently caught by the conflict of interest rules of securities legislation (“structural” conflicts) and matters that are not specifically regulated under securities legislation but which are situations where a reasonable person would consider a manager (or an entity related to the manager)

to have an interest that may conflict with the manager's ability to act in good faith and in the best interests of the fund ("operational" conflicts). It is therefore essential that managers identify transactions for their funds that fall into either category.

In the notice accompanying the publication of the Rule, the Canadian Securities Administrators ("CSA") noted that while there was no materiality threshold in the definition of a conflict of interest matter, they did not expect every conflict of interest to be referred to the IRC, as the definition incorporates a reasonable person standard. The manager is expected to look to industry best practice for guidance in identifying conflict of interest matters.

### *Structural Conflict Matters*

The IRC must *approve* the following potential structural conflict of interest matters prior to the manager proceeding with any such action: (i) inter-fund trades; (ii) certain transactions involving securities of related parties; and (iii) an investment in securities underwritten by an entity related to the manager. Additional minimum requirements are set out under the Rule in order for the manager to proceed with the foregoing actions.

An IRC must not approve an action unless it has determined, after reasonable inquiry, that the action:

- is proposed by the manager free from any influence by an entity related to the manager and without taking into account any consideration relevant to an entity related to the manager;
- represents the business judgment of the manager uninfluenced by considerations other than the best interests of the investment fund;
- is in compliance with the manager's written policies and procedures relating to the action; and
- achieves a fair and reasonable result for the investment fund.

If the IRC does not approve the proposed action, the manager cannot proceed without approval from the securities regulatory authorities.

### *Operational Conflict Matters*

For all other conflict matters, the manager may proceed with its proposed action as long as it considers the recommendation of the IRC on the matter as to whether the proposed action achieves a fair and reasonable result for the investment fund. Where the manager decides to proceed with an action without the positive recommendation of the IRC, the IRC can require the manager to notify securityholders of the manager's decision to do so.

Examples of possible operational conflicts include: (i) increasing charges to the investment fund for costs incurred by the manager in operating the fund; (ii) correcting material errors made by the manager in administering the investment fund; (iii) negotiating soft dollar arrangements with dealers with whom the manager places portfolio transactions for the investment fund; and (iv) choosing to bring services in-house over using third-party service providers.

The manager is also expected to refer to the IRC any conflict matters facing entities related to the manager (which are deemed to include portfolio managers) that may affect, or be perceived to affect, the manager's ability to act in the best interests of the fund.

### *Standing Instructions*

The Rule allows the IRC to provide the manager with standing instructions permitting the manager to act on particular types of conflict transactions on a continuing basis without seeking IRC approval, provided that the manager follows the terms and conditions of the standing instructions. The IRC is required to review and update the standing instructions as necessary at the time of its regular assessments, discussed in more detail below.

## Composition and Appointment of an IRC

An IRC must be composed of at least three members, all of whom are required to be independent. The manager must initially appoint the members, while the IRC itself must make subsequent appointments after considering the manager's recommendations. The independence requirement calls for an individual who has no *material relationship* with the manager, the investment fund or an entity related to the manager. A material relationship is one that could reasonably be perceived to interfere with the member's judgment regarding a conflict of interest matter. Such a relationship may include an ownership, commercial, charitable, industrial, banking, consulting, legal, accounting or familial relationship.

An independent member of an existing advisory board or IRC of an investment fund may be independent for the purposes of the Rule depending on the circumstances. Conversely, a person who is or has recently been an employee or executive officer of the manager, or an immediate family member of a former executive officer of the manager, would likely fail to meet the independence standard. If an investment fund has an existing board or committee that complies with the Rule, the manager, if it chooses, must still appoint such persons as members of the first IRC.

The term of office of an IRC member must be at least one year and at most three years, and must be set by the manager or the IRC, as applicable, at the time of appointment. Unless the manager agrees, no IRC member can be re-appointed by the IRC to serve more than six years. Under certain circumstances, the manager is required to notify the fund's principal regulator of the date and the reason an individual ceased to be a member of the IRC.

## Mandatory Written Charter of an IRC

Every IRC must adopt a written charter that includes its mandate, responsibilities, functions, policies and procedures. In adopting its written charter, the IRC is required to consider the manager's recommendations, if any. The charter is required to deal with the following issues, amongst others:

- protocol for the review of conflict of interest matters;
- compensation and expenses of the IRC and any advisors it employs;
- IRC member ownership of securities of the investment fund, manager or service providers; and
- suitable conduct for an IRC member facing a conflict of interest with respect to a matter being considered by the IRC.

## Obligations of the Manager

A manager must establish written policies and procedures that it must follow when referring a matter to the IRC. Such policies must be provided to the IRC for its review and input, which the manager must consider. These policies and procedures should, among other things, speak to how internal control procedures will contribute to the manager's overall ability to handle a conflict of interest.

Similar to the requirement for the IRC to keep records, the manager is required to maintain a record of any activity subject to the review of the IRC, including minutes of material discussions at meetings, copies of related policies and procedures in respect of the matter and copies of any materials, including written compliance reports, provided to the IRC.

When referring matters to the IRC, the manager must provide the IRC with sufficient information for the IRC to properly carry out its responsibilities. The manager must also make its officers available to the IRC and provide any other reasonable assistance required.

## Administration of an IRC

The Rule permits an IRC to choose whether to deliberate and decide on a conflict of interest matter in the absence of the manager, any representative of the manager and any entity related to the manager, but also requires that it hold at least one meeting annually without such persons present.

Every member of an IRC, in exercising his or her powers and discharging his or her duties related to the investment fund, must (i) act honestly and in good faith, with a view to the best interests of the investment fund; and (ii) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

The manager may set the initial compensation and expenses of an IRC. However, on an on-going basis, the IRC itself must set reasonable compensation and proper expenses for its members, and, in so doing, must consider its most recent assessment of its compensation and the manager's recommendation, if any. The investment fund must pay all reasonable costs and expenses reasonably incurred in complying with the Rule.

In order to assist the IRC to fulfill its role, the manager must provide orientation consisting of educational or informational programs that enable a new IRC member to understand (i) the role of the IRC and its members collectively; and (ii) the role of the individual member. The manager may provide a member of the IRC with educational or informational programs, as the manager considers useful or necessary, that enable the member to understand the nature and operation of the manager's and investment fund's businesses.

An investment fund and manager may indemnify a member of the IRC in the specified circumstances, including against all costs, charges and expenses reasonably incurred by the person in respect of any proceeding in which the person is involved in connection with his or her role with the IRC. This indemnification is available only if the member acted honestly and in good faith, with a view to the best interests of the fund, and, in the case of a criminal or administrative action or proceeding enforced by a monetary penalty, the member had reasonable grounds for believing his or her conduct was lawful.

An investment fund or manager may purchase and maintain insurance, on reasonable commercial terms, for the benefit of any member against any such liability incurred by the member in his or her capacity as a member.

## Reports and Assessments

At least annually, the IRC must review a number of factors prescribed by the Rule to assess the adequacy and effectiveness of the IRC. The IRC is then required to deliver to the manager as soon as practicable following its annual assessment a written report that includes a description of each instance of a breach of any of the manager's policies or procedures, and recommendations for any changes to the manager's policies and procedures.

An IRC must also prepare, for each financial year of the investment fund, a report to securityholders of the investment fund that describes the IRC and its activities for the financial year. The report should include information about the IRC members, their shareholdings in the investment fund and the manager, the IRC's compensation and a summary of its review and/or approval of conflict of interest matters. The report must also be filed with the securities regulatory authorities, and is due at the same time as the fund's annual financial statements (except the first report which is due 120 days following year end). The CSA has indicated that the IRC's report to securityholders should be prepared by the IRC only.

Finally, if an IRC is aware of an instance where the manager acted in a conflict of interest requiring approval but did not comply with a condition imposed by securities legislation or the IRC, the IRC must, as soon as practicable, notify in writing the fund's principal regulator.

## Timing Considerations

While the Rule is expected to come into force on November 1, 2006, there is a one-year transition period for most of its provisions. A manager must appoint the initial members of the IRC by May 1, 2007. If a manager would like the Rule to apply to its fund sooner (in order not to have to seek exemptive relief from the regulators for certain specified structural conflict of interest matters, for example), it must notify the fund's principal regulator. Note that, in order to do so, the fund must be completely compliant with the Rule.

The Rule also specifies that existing conflict of interest waivers and exemptions that deal with any matter that the Rule regulates will expire on November 1, 2007.

Managers will need to take a number of steps to prepare for the implementation of the Rule. For example, managers may wish to begin to:

- identify IRC members, and consider whether members sitting on an existing advisory or similar board will qualify as “independent” under the Rule;
- identify expected conflict of interest matters;
- review the constating documents of their investment funds to determine if amendments are required (e.g. to the terms relating to advisory boards or indemnification);
- consider whether any existing independent committee mandates require revision;
- consider appropriate length of term and compensation for initial IRC members;
- draft the requisite policies and procedures of the manager relating to conflict matters;
- consider the terms of an IRC charter and ongoing disclosure requirements with respect to the content of the IRC charter; and
- identify appropriate education programs for members of the IRC.

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*The foregoing provides only an overview. Readers are cautioned against making any decisions based on this material alone. Rather, a qualified lawyer should be consulted.*

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