National Instrument 81-107: An Introduction to Independent Review Committees

National Instrument 81-107 came into force on November 1st, 2006 and required existing funds to appoint the first IRC members by May 1st 2007 - so we have now had two years of experience with the regulations. *This paper describes the requirement for all publicly offered investment funds to have an* ***Independent Review Committee*** *— a uniquely Canadian model for improving fund governance - and offers fund managers and prospective new IRC members an overview of the requirements of NI 81-107.*

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Executive Summary

Pursuant to **National Instrument 81-107 t**he manager of every investment fund that is a reporting issuer in a Canadian province must establish a fully independent body, called an **Independent Review Committee**, whose role is to oversee all decisions involving an actual or perceived conflict of interest faced by the manager in the operation of the fund.

In the case of a new fund, the investment fund should be fully compliant with NI 81-107 before any purchase order for securities of the fund is accepted.

The IRC must consist of at least three individuals, all of whom must be independent. The IRC is a separate governance body from the fund or the manager and the IRC members are not, serving in that capacity, either directors or officers of the fund or the manager.

Under the Instrument, the main role of the IRC is to review conflicts of interest that may arise between the manager's own interests and the manager's duty to manage an investment fund in the best interests of the fund. The Instrument provides, therefore, that the manager must refer all conflict of interest matters, and its proposed course of action on those matters, to the IRC for the IRC's review or determination.

A manager should not underestimate the amount of time that the senior management will have to spend in setting up and running an IRC.

A manager can choose to operate the IRC using its internal administrative resources. Alternatively, the IRC can outsource the administrative functions to an independent "secretariat" (i.e., an office and/or official(s) entrusted with administrative duties, maintaining records, and overseeing or performing secretarial duties, for the IRC).

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National Instrument 81-107: An Introduction to Independent Review Committees

Introduction

National Instrument 81-107 *Independent Review Committee for Investment Funds* (the Instrument) came into force on November 1st, 2006. The Instrument sets out an independent oversight regime for all publicly offered investment funds which is intended to improve investment fund governance in Canada.

The International Organization of Securities Commissions defines investment fund governance as a framework for the organization and operation of investment funds that seeks to ensure that funds are organized and operated in the interests of fund investors, and not in the interests of fund insiders.

Improving fund governance has been a priority for the Canadian securities regulators for several years. The process began in the 1990s with a debate over the need for independent boards for mutual funds and increased regulatory standards for fund managers.

National Instrument 81-107 now imposes a minimum, consistent standard of independent oversight for all publicly offered investment funds in each of the jurisdictions represented by the Canadian Securities Administrators (the CSA). The new rules embody the emerging international standards on fund governance but the CSA has tailored these to the specific structures of the Canadian investment fund industry and the Independent Review Committee model is unique to Canada.

Scope of National Instrument 81-107

The Instrument requires every investment fund that is a reporting issuer to have a fully independent body, called an Independent Review Committee (the IRC), whose role is to oversee all decisions involving an actual or perceived conflict of interest faced by the fund manager in the operation of the fund.

The Instrument applies to all investment funds that are reporting issuers (i.e. that are offered to the public) and, importantly, to the managers of those funds. This includes all publicly-offered mutual funds, labour sponsored or venture capital funds, scholarship plans, mutual funds and closed-end funds that are listed and posted for trading on a stock exchange or quoted on an OTC market, and non-redeemable investment funds.

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The Instrument does not regulate mutual funds (commonly referred to as pooled funds) that sell securities to the public only under capital raising exemptions permitted by securities legislation (and which, therefore, are not reporting issuers).

As IRCs become more familiar, even private and exempted funds may well find that pressure from institutional investors requires them to voluntarily adopt similar standards of fund governance.

The Composition of an IRC

An IRC must have at least three members. Every IRC member must be completely independent from the relevant fund(s) and the manager. The IRC must appoint one member as "Chair" of the committee.

The size of the IRC is determined by the manager, with a view to facilitating effective decision-making, and may only be changed by the manager.

The Instrument does not mandate a specific legal structure for the IRC, but the 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 the committee. For example, a manager may establish a separate IRC for each of the investment funds it manages, or establish more than one IRC where each IRC acts for several of its investment funds, or it may establish just one IRC for all of its investment funds.

One committee can act as the IRC for multiple funds that are managed by the same manager and the Instrument states that it does not prevent investment funds from sharing an IRC with investment funds managed by another manager.

The Instrument, suggests that sharing an IRC may be a more cost-effective way to establish an IRC for smaller fund families.

The Role of an IRC

It is a core principle of Canadian investment fund regulation that the fund manager has the responsibility and accountability for managing its funds in accordance with its fiduciary responsibilities. Accordingly, the CSA did not seek to impose independent board structures on the Canadian investment fund industry, as in the U.S. Instead, they have crafted a unique model and assigned a limited role and functions to the IRC.

Under the Instrument, the main role of the IRC is to review conflicts of interest that may arise between the fund manager's own interests and the manager's duty

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to manage an investment fund in the best interests of the fund. The Instrument provides, therefore, that the manager must refer all conflict of interest matters, and its proposed course of action on those matters, to the IRC for the IRC's review or determination.

In respect of certain conflict of interest matters (where the manager is otherwise prohibited from taking action by securities legislation) the IRC must *approve* the manager's proposed actions. In respect of all other conflict of interest matters referred to the IRC by the fund manager, the IRC is required to make a recommendation to the manager as to whether, in the opinion of the IRC, the manager's proposed action achieves a fair and reasonable result for the investment fund.

The IRC is obligated to consider every matter referred to it and provide either a determination (on those matters where the IRC's approval is required) or its recommendation (on all other conflict of interest matters).

The manager must abide by the decision of the IRC on those matters that require its approval (subject to a manager's overriding right to seek "exemptive relief" from its regulator). A manager must consider the recommendation of the IRC in respect of other conflict of interest matters, but may disregard the recommendation of the IRC, after such consideration.

An Independent Perspective

The Instrument is premised on the belief that a manager may not be able to objectively determine whether it is acting in the best interests of the investment fund when it has a conflict of interest. The Instrument thus requires managers to refer all conflict of interest matters – not just those subject to prohibitions or restrictions under securities legislation - to an IRC so that an independent perspective can be brought to bear on the manager's proposed action.

The IRC is expected to bring a high degree of rigour and skeptical objectivity to its review of conflict of interest matters, but the CSA expressly states that they do not consider it the role of the IRC to second-guess the investment or business decisions of a manager or an entity related to the manager.

Rather like the role of the Senate in Canada, an IRC is supposed to provide a "sober second review" of the manager's proposed course of action in respect of a conflict of interest matter.

Under the Instrument, an IRC does not, therefore, have the general responsibility to oversee or supervise the management of the investment fund. Indeed, the Instrument states that the IRC has no power, authority or responsibility for the operation of the investment fund or the manager except as described above. Instead, the IRC will assist the manager to prepare written policies and procedures concerning matters

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that must be referred to it and, thereafter, the committee's role is to react when the manager refers a matter to it and to conduct annual reviews.

It is important to note that IRC members are not, in that capacity, either directors or officers of the relevant fund(s) or of the manager.

Matters Requiring IRC Approval

The conflict of interest matters in respect of which a manager cannot take any action without IRC approval are:

- Inter-fund trading;
- Purchasing or continuing to hold securities of issuers related to the manager; and
- Purchasing securities underwritten by entities related to the manager within 60 days of the end of the distribution period for those securities.

The Instrument relieves an investment fund from seeking regulatory approval for an action which would otherwise breach these specific investment restrictions, so long as the IRC has carefully reviewed the matter and given its approval, before the manager acts. In practice, this (generally) only benefits the large fund groups that regularly bump into the related-party and self-dealing investment prohibitions.

Additional Functions

In addition to its main role, the IRC must also:

- Review and provide input on the manager's written policies and procedures concerning conflict of interest matters (see "**Manager's Obligations**" below);
- Provide input to the manager on any proposal to change the size of the committee;
- Prepare and approve a Written Charter (see "**Written Charter**" below);
- Hold at least one meeting annually at which the manager, any representative of the manager or any entity related to the manager, are not in attendance;
- Prepare an annual report and conduct certain reviews, at least annually (see "**IRC's Self-Assessment Functions**" below); and
- In the case of mutual funds, approve certain fund mergers proposed by the manager and approve a change of fund auditor proposed by the manager (see "**Matters Requiring the Prior Approval of Securityholders**" below).

It is important to note that the manager and the IRC may mutually agree that the IRC should have a broader mandate and perform functions in addition to those prescribed by the Instrument or elsewhere in securities legislation. For example, the IRC may be

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tasked with monitoring the performance, administration and management of the investment fund or giving general advice to the manager. Where broader responsibilities are agreed with the manager the Instrument requires that the additional functions must be described in the written charter of the IRC, but the Instrument does not regulate those additional functions.

Conflict of Interest Matters

The Instrument states that the manager must refer every "conflict of interest matter" to the IRC.

The Instrument does not set out a list of matters which raise a conflict of interest. Instead it sets out a principles-based test to determine when a fund manager must refer a matter to the IRC. As a general principle, a "conflict of interest matter" is defined as a matter in respect of which a reasonable person would consider that the manager (or an entity related to the manager) has an interest that may conflict with the manager's ability to act in good faith and in the best interest of the investment fund.

The first part of the test is "does the manager (or an entity related to the manager) have an interest" in the matter. Where that requirement is met, this broad test covers perceived conflicts ("an interest that **may** conflict with the manager's ability to act in good faith and in the best interest of the investment fund") as well as actual conflicts.

The Instrument regulates two types of conflicts: (a) "business conflicts" - which relate to the operation by the manager of its funds and which were not previously regulated under securities legislation, except through the general fiduciary duties imposed on the fund manager; and (b) "related-party conflicts" – which are those conflicts resulting from proposed transactions by the manager with related entities of the manager, fund or portfolio manager (i.e. those related-party and self-dealing transactions which are prohibited or restricted by securities legislation).

Business conflicts include a manager's business and commercial decisions made on behalf of the investment fund that may be motivated, or be perceived to be motivated, by the manager's own interests rather than the best interests of the investment fund. Examples of business conflict of interest matters, including those provided by the CSA, are:

a) proposed increased charges to the investment fund for costs incurred by the manager in operating the fund and other fee/expense allocation issues;
b) correcting material errors made by the manager in administering the investment fund;
c) negotiating soft dollar arrangements with dealers with whom the manager places portfolio transactions for the investment fund and other best execution issues;

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d) choosing to bring services in-house over using third-party service providers;
e) personal trading by the manager's staff; and
f) allocation of investments between funds.

By way of further guidance, the CSA indicate that they do not regard the "reasonable person" test as capturing "inconsequential matters". This provides a "de minimis" exception for minor issues.

In determining what conflict of interest matters are caught by the Instrument, and which issues are *de minimis,* the manager is required to have regard, *inter alia,* to industry best practices.

In respect of entities related to the manager, the Instrument does include sub-advisors, but states that "*The types of conflicts of interest faced by the portfolio manager or portfolio adviser (or sub-adviser) or any other entity related to the manager this Instrument captures relate to the decisions made on behalf of the investment fund that may affect or influence the manager's ability to make decisions in good faith and in the best interests of the investment fund.*"

The Instrument states that it is not intended to regulate conflicts of interest at the service provider level generally.

Appointment and Removal of IRC Members

The manager must appoint the first members of the fund's IRC. Thereafter, only the IRC members themselves can fill any casual vacancies.

However, if all the members of an IRC cease to be members at the same time (e.g. if the manager of the fund changes or all of the members resign at the same time), the Instrument requires the manager to appoint new members "as soon as practicable".

The Instrument requires that an IRC member's term of office must be at least 1 year and not more than 3 years in length, although a member can be reappointed after his or her term expires. However, a member may not be reappointed for a term or terms of office that, if served, would result in the member serving on the IRC for longer than 6 years, unless the manager agrees to the reappointment in writing.

The guidance notes contain a recommendation from the regulators that all members be appointed with staggered terms. Where the members of the committee have been selected by the manager there may be a perception that the IRC members would be biased in favour of the manager that appoints them. Having staggered terms ensures that subsequent appointments (or re-appointments) are made by the IRC and not by the manager, thus ensuring continuity and continued independence from the manager.

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An IRC may establish its own nominating criteria for the appointment of new members but before appointing a new member it must always consider:

(a) the competencies and skills the IRC, as a whole, should possess;
(b) the competencies and skills of each other member of the IRC; and
(c) the competencies and skills the prospective member would bring to the IRC.

The members of the IRC may seek assistance from the manager in the selection and recruitment process and will normally consult with the manager when making subsequent appointments. The IRC must consider the manager's recommendations, if any, when filling a vacancy.

An IRC member continues to be a member of the IRC until his or her term ends or he or she resigns or is otherwise disqualified from continuing as a member of the IRC. A member can also be removed by a majority vote of the other members of the IRC. In addition, a member of an IRC automatically ceases to be a member when the relevant investment fund is terminated or the manager of that mutual fund changes (or there is a change in the control of the manager).

The Instrument seeks to ensure that an IRC member is free to perform his or her duties without fear of being dismissed or removed by the manager. Accordingly, the fund manager may only seek to remove a member or members of an IRC by calling a meeting of the securityholders of the investment fund and asking them to approve the removal by way of a majority vote. If that happens, the member may submit to the manager a written statement giving reasons for opposing his/her removal and the manager must send a copy of the statement to every securityholder entitled to receive notice of the meeting and to the member.

A manager must notify the fund's principal regulator whenever an IRC member resigns, is removed or not reappointed, explaining the reason for such event.

Meaning of "Independence" for IRC Members

All members of an IRC must be independent within the meaning of the Instrument. An individual is not regarded as independent if he or she has a material relationship with the manager, the investment fund or an entity related to the manager. For this purpose, a material relationship is defined in the Instrument as a relationship which could reasonably be perceived to interfere with the member's judgment regarding a conflict of interest matter.

Given that the principal function of the IRC is to review activities and transactions that involve inherent conflicts of interest between an investment fund and its manager, the CSA believe that it is important that the members of the IRC are free from conflicting loyalties.

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The Instrument indicates that a material relationship may include an ownership, commercial, charitable, industrial, banking, consulting, legal, accounting or familial relationship, either past or current Otherwise, the Instrument provides very limited guidance on the range of material relationships that would affect an individual's independence. The most obvious relationships set out in the Instrument as unlikely to be independent are where a person is, or has recently been, an employee or executive officer of the manager or the investment fund or where a person's immediate family member is, or has recently been, an executive officer of the manager or the investment fund. No guidance is given on the length of time that must elapse after the officer or employee leaves in order to "sanitize" the relationship.

Retired partners of law and accounting firms, and former asset managers or securities regulators are likely to meet this independence test for most funds, provided that they do not have any ongoing, material relationship with the manager or the investment fund.

The Instrument contemplates that IRC members may well own securities of the investment fund, and/or the manager or in a person or company that provides services to the investment fund or the manager. The IRC's written charter is required to set out a policy on such ownership, and the IRC's annual report to securityholders must disclose any IRC member's ownership interest in the manager or in a person or company that provides services to the investment fund or the manager, and the total level of IRC members' ownership of securities in the investment fund (but only if the aggregate level of such ownership exceeds 10%). Whether such an ownership interest held by a member of an IRC compromises the independence of the relevant member is a question that will depend on the facts in each case and must be determined on a "case-by-case" basis. The test is always, "would the ownership interest cause a reasonable person to question the member's independence?"

The Instrument states that the IRC's ability to set its own reasonable compensation does not create a material relationship with the manager or investment fund.

To increase the perceived independence of the committee, the manager should ideally ensure that the IRC also operates independently of the management of the fund (see "**The Establishment and Administration of an IRC**" below).

Recruitment of Qualified Individuals for an IRC

One of the most difficult tasks that new investment funds and existing IRCs face is finding suitable prospective members for an IRC. The individuals must have relevant experience and be totally independent within the meaning of the Instrument.

While the Instrument has a test for the level of independence required for membership, it does not set any minimum qualification or experience requirements for individuals. However, the Instrument states that before appointing a member the

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manager or the IRC (whichever is making the appointment) must consider the competencies and skills that the IRC, as a whole, should possess; the competencies and skills of each member of the IRC; and the competencies and skills the prospective member would bring to the IRC.

In respect of each prospective member it would be appropriate to consider their knowledge and experience in the investment fund sector; their overall experience in the financial services industry; their professional qualifications and background; their integrity and business judgment; and their degree of Canadian and international fund governance experience. In addition, the manager and the IRC should try to create a balance of legal, accounting and general investment fund business experience within the committee as a whole.

If the manager chooses the individual members on its own there may well be a perception that the IRC members would be biased in favour of the manager that appoints them. On the other hand, using outside recruitment agencies by the manager or an IRC involves the payment of significant "search" fees.

The fund has to pay the individuals a fee for serving as members of the IRC. Currently the annual retainer fees range from a low of $1,000 to a high of $75,000 for an IRC Chair. Some IRCs also pay a "per meeting" fee.

IRC's Standard of Care

The Instrument requires that the IRC must carry out its responsibilities having regard to the standard of care set out in the Instrument, which is as follows:

Every member of an IRC, in exercising their powers and discharging their duties related to the investment fund (but not to any other person), as a member of the IRC must:

a) act honestly and in good faith, with a view to the best interests of the investment fund (meaning, normally, the interests of the securityholders in the investment fund as a whole); and
b) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

The Instrument further states that a member of an IRC has complied with his or her duties under sub-paragraph a) if the member has relied in good faith on a report or certification represented to the IRC as full and true by the manager (or an entity related to the manager) or a report by a person whose profession lends credibility to a statement made by that person. In addition, a member of an IRC will not contravene the standard of care set out in sub-paragraph b), if he or she exercises the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, including reliance on such a report or certification.

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In respect of the fiduciary duty created by sub-paragraph a), Davies Ward Phillips & Vineberg LLP have advised the Ontario Securities Commission, as follows:

"In our view, it is likely that [sub-paragraph a)] would be interpreted in the way the parallel provision in the corporate statutes is interpreted. That is, an IRC Member would have a fiduciary duty to the Fund, but not to the individual [securityholders] of the Fund, or to any other stakeholders (such as creditors). The fact of the Fund being structured as trust would not alter this analysis in any material way."

In addition, the CSA expressly state that it is not their intention to create a duty of care on the part of the IRC to any other person under sub-paragraph b). This is intended to address the issue raised by the Supreme Court of Canada in the *Peoples v. Wise* decision. In that decision, the Court noted that a director's duty of care is not owed exclusively to the corporation and that others (such as creditors) could complain that they had suffered damage as a result of a director's failure to act in accordance with that duty.

The Instrument also permits a manager to purchase insurance for the IRC members (and charge that expense to the investment fund) and allows the investment fund to indemnify the members of an IRC, except in respect of willful misconduct, bad faith or breach of the fiduciary duty outlined above.
Most IRC members are being offered a full indemnity from both the manager and the relevant fund(s) and some form of professional indemnity insurance. This may take the form of an additional limit on an existing D&O policy (to which the IRC members are added as "named insured") or a standalone IRC policy. The ideal scenario for an IRC member is strong indemnities, a D&O limit and a separate, standalone policy for the IRC.

IRC's Written Charter

The Instrument states that the IRC must adopt a written charter that sets out its mandate, responsibilities and functions, and the policies and procedures it will follow when performing its functions. The IRC should consult with the manager on its charter and must consider the manager's recommendations, if any.

An IRC that acts for more than one fund complex may establish a separate charter for each fund complex or it may choose to establish one charter for all of the investment funds it acts for.

The Instrument indicates that the regulatory authorities expect an IRC's written charter to set out the necessary policies and procedures to ensure the IRC performs its role adequately and effectively and in compliance with the Instrument.

The CSA indicate that the written charter should include the following:

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a) the policies and procedures the IRC must follow when reviewing conflict of interest matters;
b) criteria for the IRC to consider in setting its compensation and expenses and the compensation and expenses of any advisors employed by the IRC;
c) a policy relating to IRC member ownership of securities of the investment fund, manager or in any person or company that provides services to the investment fund or the manager;
d) policies and procedures that describe how a member of the IRC is to conduct himself or herself when he or she faces a conflict of interest, or could be perceived to face a conflict of interest, with respect to a matter being considered or to be considered by the IRC;
e) policies and procedures that describe how the IRC is to interact with any existing advisory board or board of directors of the investment fund and the manager; and
f) policies and procedures that describe how any subcommittee of the IRC is to report to the IRC.

The IRC is expected to review the committee's charter on a periodic basis at least once per year (see **"IRC's Annual Review Functions"** below).

Where broader responsibilities than the limited mandate set out in the Instrument are assumed by the IRC, and agreed in writing with the manager, the Instrument requires that the additional functions must be described in the written charter of the IRC (but the Instrument does not then regulate those additional functions).

IRC's Authority

Pursuant to the Instrument, an IRC has the authority to:

a) Obtain such information from the manager and its senior executives as it determines is useful or necessary to carry out its duties;
b) At the expense of the fund, engage independent legal counsel or other advisors it determines useful or necessary to carry out it duties (collectively "Outside Counsel") and set reasonable compensation and proper expenses for such Outside Counsel;
c) Set reasonable compensation and proper expenses for the members of the IRC (e.g., the costs of an independent secretariat for the IRC);
d) Delegate any of its functions, except the removal of a member, to a subcommittee of at least three members of the IRC; and
e) Communicate directly with the securities regulatory authorities with respect to any matter (see **"Reporting to the Regulators"** below).

The CSA state that they expect that an IRC will use Outside Counsel selectively and only to assist, not replace, the IRC's decision-making. The CSA do not anticipate that IRCs will routinely use Outside Counsel.

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IRC Meetings and Operating Procedures

One member of an IRC must be appointed as “Chair” of the IRC. The Chair is responsible for “managing the mandate, and responsibilities and functions” of the IRC.

The Chair of the IRC should lead IRC meetings, foster communication among IRC members, and ensure that the IRC carries out its responsibilities in a timely and effective manner. The guidance notes also indicate that the CSA expect the IRC Chair to be the primary person to interact with the manager on issues relating to the fund and anticipate that the Chair will have “regular communication” with the manager in order to keep up to date on the affairs of the investment fund between meetings.

In order to maintain its independence, the IRC can choose to deliberate on matters in the absence of any representative of the manager or any entity related to the manager. However, an IRC may receive written and/or oral submissions from the manager and an IRC must hold at least one meeting annually at which the manager, any representative of the manager or any entity related to the manager, are not in attendance.

In addition, the IRC may discuss or hold meetings with other persons who can help the members understand matters that are beyond their specific expertise or can explain industry practices or trends.

The IRC must make decisions on any conflict of interest matter referred to it, or any other matter that securities legislation requires the IRC to review, by way of the agreement of a majority of the members of the IRC (NB: Not a majority of those present and voting at a meeting, as is usual with a board of directors). So, for example, if the IRC has 3 members, a decision requires at least 2 members approval and if the IRC has 4 or 5 members, a decision requires at least 3 members approval). If the IRC only has 2 members, any decision on such matters must be unanimous. If the IRC only has one member, that member may not make such a decision, and can only act to appoint additional members.

Matters Requiring the IRC’s Approval

On those conflict of interest matters where the IRC must approve the manager’s proposed action, the IRC must not approve the action unless it has determined, after reasonable enquiry, that the action:

1. Is proposed by the manager free of any influence by any entity related to the manager and without taking into account any consideration relevant to an entity related to the manager;
2. Represents the business judgment of the manager uninfluenced by considerations other than the best interests of the investment fund;

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3. Is in compliance with the manager's written policies and procedures relating to the action; and
4. Achieves a fair and reasonable result for the investment fund.

Clearly, the IRC should seek a written report or certification from the manager on each of these points before proceeding to a decision.

Matters Requiring a Recommendation from the IRC

In respect of other conflict of interest matters referred to it, after reviewing the manager's proposed action, the IRC must provide a recommendation to the manager as to whether, in the opinion of the IRC, the proposed action achieves a fair and reasonable result for the investment fund. The guidance notes indicate that the recommendation must state whether or not the IRC views the proposed action as achieving a fair and reasonable result for the investment fund (i.e., either a positive or a negative recommendation must be given).

Please note that the manager's proposed action may not be the only way of dealing with the conflict – so long as it achieves a fair and reasonable result for the fund.

Standing Instructions

The Instrument allows an IRC to give a fund manager a "standing instruction" that permits the manager to act in a pre-agreed way in a conflict of interest matter, on such terms and conditions as the IRC requires.

In the Instrument, "standing instruction" means a written approval or recommendation from the IRC that permits the manager to proceed with a proposed action on an ongoing basis, without having to refer the conflict of interest matter or its proposed action to the IRC, provided that the manager complies with the terms of the standing instruction.

A standing instruction is particularly useful for managers in respect of time sensitive matters, such as inter-fund trading and the sale or purchase of securities of related issuers, where it may not be practicable to keep referring the proposed action to the IRC for review.

A standing instruction must be re-considered in detail every year as part of the IRC's regular annual assessment and, as part of the assessment process, the manager must inform the IRC, in writing, of each occasion that it has dealt with a conflict of interest matter in accordance with the standing instruction. The IRC must then re-evaluate the adequacy and effectiveness of the standing instruction, review the manager's policies and procedures in respect of such matters and then reaffirm or amend the standing instruction.

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A manager may continue to rely on a standing instruction until such time as the IRC notifies the manager that the standing instruction has been amended or is no longer in effect.

Sub-Committees

An IRC which has more than three members has the authority to delegate any of its functions to a subcommittee of at least three members of the IRC, except the power to remove a member of the committee.

Where an IRC does delegate some functions to a subcommittee, the written charter of the IRC should include a defined mandate and reporting requirements for such subcommittees. The subcommittee must report on its activities to the IRC, and the IRC must review and assess the adequacy and effectiveness of the subcommittee, at least annually.

The CSA state that they do not consider delegation by the IRC of a function to a subcommittee will absolve the IRC from its ultimate responsibility for the function.

IRC Record Keeping

Under the Instrument, an IRC must keep records in accordance with existing best practices for independent review committees, including maintaining a record of:

1. Its written charter;
2. Minutes of its meetings (minutes should be prepared and retained in respect of any material discussions the IRC has at meetings with the manager or internally on matters subject to its review);
3. Any materials and written reports provided to it;
4. Its own materials and written reports; and
5. Its own decisions and recommendations.

The manager must also maintain a record of any activity that is subject to the review of the IRC, including keeping minutes of any material discussions it has at meetings with the IRC or internally on matters subject to the review of the IRC.

The guidance notes indicate that the IRC should also keep records with regard to any actions it takes in respect of a matter referred to it and, in particular, its actions in respect of any transaction which would otherwise have been prohibited or restricted by securities legislation (e.g. inter-fund trading, transactions in securities of related issuers, and purchases of securities underwritten by related underwriters), for which the manager has sought the approval of the IRC.

Subject to these minimum requirements, the IRC may conduct its proceedings as it sees fit.

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In Ontario, the IRC is expressly designated as a market participant under the Securities Act. This is to ensure that the books, records and documents required to be kept by the IRC may be requested by the Ontario Securities Commission under Part VII of the Securities Act. The IRC members must therefore ensure that proper books and records are maintained by the IRC at all times. The CSA indicate that the IRC and the manager may share record keeping and maintain joint records of IRC and manager meetings.

IRI's independent secretariat service ensures that the IRC's records are maintained in accordance with the requirements of the Instrument and the best practices in the industry. In addition, IRI puts the IRC's records online, in a secure "IRCExtranet", so that they are available to the IRC members and the manager at all times.

Enforcement Issues

If the manager of an investment fund chooses not to follow the recommendation of the fund's IRC there are no statutory enforcement provisions. This reflects the fact that it is the fund manager who has the ultimate responsibility and accountability for managing the fund.

However, if the manager decides not to follow the recommendation of the IRC where, in the opinion of the IRC after reasonable inquiry, the manager's proposed action does not achieve a fair and reasonable result for the investment fund, then the manager must notify the IRC in writing before proceeding with the proposed action. The IRC may then require the manager to notify securityholders in the investment fund of the manager's decision — at the expense of the manager.

The notification to securityholders must:

(a) sufficiently describe the proposed action of the manager, the recommendation of the IRC and the manager's reasons for proceeding;
(b) state the date of the proposed implementation of the action; and
(c) be sent by the manager to each securityholder of the investment fund at least thirty days before the effective date of the proposed action.

The investment fund must, as soon as practicable, file the notification with the securities regulatory authority or regulator upon the notice being sent to securityholders.

The manager is also required by the Instrument to disclose in the investment fund's prospectus and in its periodic continuous disclosure reports any instances where the manager did not follow a recommendation of the IRC, the general nature of the recommendation and the reasons for not following the recommendation.

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This type of disclosure obligation has proven to be effective in other areas of corporate governance. For example, in the U.K., public companies are required to provide details in their annual reports of any areas where the company does not comply fully with the regulator's Code of Best Practice for Corporate Governance. In the context of Canada's highly competitive investment fund industry, and where investors have daily liquidity, this type of "name and shame" provision should be an effective deterrent for managers.

An IRC does not have the ability to compel a manager to call a meeting of securityholders to consider a specific conflict of interest matter.

The IRC must report in writing to the regulators as soon as practicable after it becomes aware that a manager has proceeded to act in a conflict of interest matter that requires the IRC's prior approval, without such approval, or has not met a condition imposed by the IRC when giving such approval.

The guidance notes state that in circumstances where the fund manager has not met a condition imposed by the IRC when giving such approval, that the manager is in breach of securities legislation and the regulators may require the manager to unwind the transaction and pay any costs associated with doing so. It is incumbent on the manager to also report any such breach to the regulators.

Ultimately, the members of the IRC can resign, and make the reason for their resignation public, if the manager persistently fails to follow their recommendations.

IRC's Regular Assessment Functions

Pursuant to the Instrument, the IRC must conduct regular assessments, including a self-assessment at least once every year, but may establish a process for, and determine the frequency of, additional assessments, as it sees fit.

Self-Assessment Function

As part of its self-assessment, the IRC must, at least annually, review and assess:

(a) the independence of the IRC members and the compensation of the IRC members;
(b) the adequacy and effectiveness of any subcommittee it has appointed.

The IRC must also review and assess its effectiveness as a committee, as well as the effectiveness and the contribution of each of the IRC members.

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The IRC's review of its effectiveness, and the effectiveness of each of its members, must include a consideration of:

(a) the IRC's written charter;
(b) the competencies and knowledge each member is expected to bring to the IRC;
(c) the level of complexity of the issues reasonably expected to be raised by members in connection with the matters under review by the IRC; and
(d) the ability of each member to contribute the necessary time required to serve effectively on the IRC.

When evaluating the IRC's structure and effectiveness, the IRC must consider at least the following factors:

(a) the frequency of meetings;
(b) the substance of meeting agendas;
(c) the policies and procedures that the manager has established to refer matters to the IRC;
(d) the usefulness of the materials provided to the IRC members;
(e) the collective experience and background of the IRC members;
(f) the number of funds the IRC oversees; and
(g) the amount and form of compensation the IRC members receive from the fund and in aggregate from the fund family.

When evaluating an individual IRC member's performance the IRC must consider at least the member's:

(a) attendance and participation record;
(b) continuing education activities; and
(c) industry knowledge.

The guidance notes indicate that the regulators expect the annual self-assessment by the IRC to improve performance by strengthening each member's understanding of his or her role and fostering better communication and greater cohesiveness among members.

The guidance notes also indicate that the regulators expect the IRC to respond appropriately to address any weaknesses revealed in the self-assessment review — including making recommendations to the manager, where relevant, to improve the quality or quantity of information provided to it or to reduce the workload of the IRC or to increase continuing education or, in rare circumstances, to change the composition of the IRC. The IRC should consider any feedback received from the manager during its self-assessment review.

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Evaluation of Interactions with the Manager

The IRC's regular assessments must also include a review, at least once each year, of its interactions with the manager, including a review and assessment of the:

(a) adequacy and effectiveness of the manager's written policies and procedures concerning conflict of interest matters;
(b) manager's and each fund's compliance with any conditions imposed by the IRC in a recommendation or approval it has provided to the manager;
(c) adequacy and effectiveness of any standing instruction it has provided to the manager; and
(d) manager's and each fund's compliance with any conditions imposed by the IRC in each standing instruction.

Reporting to the Manager

An IRC must report its findings to the fund manager, in writing, as "soon as practicable" after completing these regular assessments and such report must also include:

a) a description of each instance of a breach of any of the manager's policies or procedures of which the IRC is aware, or that it has reason to believe has occurred;
b) a description of each instance of a breach of a condition imposed by the IRC in a recommendation or approval it has provided to the manager, of which the IRC is aware, or that it has reason to believe has occurred; and
c) recommendations for any changes the IRC considers should be made to the manager's policies and procedures.

Reporting to Securityholders

The IRC must also produce an annual report to securityholders, for each financial year of the investment fund, and the report must describe the IRC and its activities for the financial year. The Instrument requires the preparation of a very detailed report covering the make-up, composition and aggregate compensation of the IRC, a brief summary of any recommendations and approvals (not limited to standing instructions) that the manager relied upon during the period, and any instances where the manager did not follow a recommendation of the IRC or failed to comply with a condition imposed by the IRC.

The report must describe any relationships that may cause a reasonable person to question any member's independence and the basis upon which the IRC determined that the member is independent, and also include a statement of the aggregate

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amount of securities held by the members of the IRC in the relevant investment fund (if the aggregate level of ownership exceeds 10%) and/or the manager. In addition, in instances where a member could reasonably be perceived to not be "independent" under this Instrument because that member holds an interest in any person or company that provides services to the investment fund or the manager, then the report must disclose the percentage interest that the member holds.

The report must also describe the process and criteria used by the IRC to determine the compensation of it members, any instances where the IRC has not followed a recommendation of the manager in deciding the compensation and expenses of its members, together with a summary of the manager's recommendation, and the reasons for not following the recommendation. This disclosure obligation should help keep the future costs of maintaining the IRC in line with the manager's expectations.

The IRC's annual report must be prepared and filed no later than the date the investment fund files its annual financial statements. The report must be delivered by the IRC to the manager and also filed with the regulators and made available for securityholders (by being prominently displayed throughout the year on the home page of the fund's, or the fund manager's, web site — as applicable — and sent to any securityholder that requests one, without charge). The report must be filed on the SEDAR group profile number of the investment fund as a continuous disclosure document (at the expense of the fund).

Relationship with and Reporting to the Regulators

IRCs are expressly given the authority under the Instrument to communicate directly with the securities regulators.

In particular, an IRC must report in writing to the regulators as soon as practicable after it becomes aware that a manager has proceeded to act in a conflict of interest matter that requires the IRC's prior approval, without such approval, or has not met a condition imposed by the IRC when giving such approval. The IRC report should include details of the steps the manager proposes to take, or has taken, to remedy the breach, if known by the IRC.

However, the CSA indicate that these types of notification are not intended to be a mechanism to resolve disputes between an IRC and a manager, or for the IRC to raise inconsequential matters with the securities regulatory authorities.

The guidance notes encourage an IRC to inform the regulators of "any concerns or issues" that the IRC is not otherwise required to report (e.g. if very few matters have been referred to the IRC by a manager, or where the IRC has found, or has reasonable grounds to suspect, a breach of securities legislation has occurred). However, the Instrument makes it clear that an IRC has no obligation to report matters to the

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regulators, other than those matters which are prescribed by the Instrument or elsewhere in securities legislation.

A manager must not prevent, or attempt to prevent, the IRC or a member of the IRC from communicating with the regulators. On the other hand, the guidance notes indicate that the CSA do not view any provisions of this Instrument as preventing the manager from communicating with the securities regulatory authorities with respect to any matter.

Members of an IRC in Ontario should also note that as designated market participant for the purposes of the *Securities Act* (Ontario) the IRC is subject to the review and sanction powers of the OSC.

Matters Requiring the Prior Approval of Securityholders

Changes of auditors for mutual funds and a reorganization or transfer of assets of a mutual fund to another mutual fund managed by the same fund manager or an affiliate, used to require the prior approval of securityholders. The Instrument now states that the manager will not also have to obtain securityholders' approval, provided that:

a) the IRC approves these changes; and
b) the simplified prospectus of the mutual fund discloses that, although the approval of securityholders will not be obtained before making the change, securityholders will be sent a written notice at least 60 days before the effective date of the change.

Once the IRC has approved such a change, Securityholders are required to be given at least 60 days' notice prior to the effective date of the change. Amendments to *National Instrument 81-102 Mutual Funds* also give effect to this change.

The ability to obtain the IRCs approval, and thereby avoid a securityholder vote on these matters, represents a significant cost saving for funds that are making such changes since a securityholder vote can cost upward of $250,000 to arrange.

It is important to note that there are still some matters that are subject to a securityholder vote under securities legislation that will also now be a "conflict of interest matter" subject to the Instrument. (e.g., increases in the charges of the manager to a mutual fund will be a conflict of interest matter as well as a matter subject to a securityholder vote under Part 5 of *National Instrument 81-102 Mutual Funds*). For these types of matters, the manager must refer the matter first to the IRC before seeking the approval of securityholders, and must include a summary of the IRC's decision in the written notice to securityholders.

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The Manager’s Obligations

In addition to the obvious obligation on the manager to establish an IRC and appoint the first members, the Instrument sets out several new obligations on the manager of an investment fund.

In the Instrument, “manager” means a person or company that directs the business, operations and affairs of an investment fund.

Manager’s Standard of Care

The Instrument states that in managing an investment fund the manager must:

a) act honestly and in good faith, and in the best interests of the investment fund; and
b) exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

This standard is essentially the same as the standard required under section 116 of the Securities Act in Ontario and creates a uniform standard of care across Canada for all managers of investment funds subject to the Instrument.

Referring proposed actions involving conflict of interest matters to the IRC for its review does not detract from the manager’s overriding obligations to the investment fund under securities legislation to make decisions in the best interests of the fund.

Manager Must Refer Matters to the IRC

Whenever a conflict of interest matter arises, and before taking any action in the matter, the manager must:

a) determine what action it proposes to take in respect of the matter, having regard to:
    i. its duties under securities legislation (i.e. the manager’s standard of care); and
    ii. its written policies and procedures on the matter; and
b) refer the matter, along with its proposed action, to the IRC for its review and decision.

When referring a matter to the IRC, a manager should inform the IRC whether its proposed action follows its written policies and procedures on the matter.

Manager’s Written Policies and Procedures

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Before proceeding with a conflict of interest matter or any other matter that securities legislation requires the manager to refer to the IRC, the manager must establish written policies and procedures which must be followed on that matter or on that type of conflict of interest matter.

This means that the manager must identify in advance, for each investment fund it manages, all conflict of interest matters that it expects will arise and which will be required to be referred to the IRC. The manager's conflict of interest matters written policies and procedures must be submitted to the IRC for its review and the manager must consider the input of the IRC on the policies, if any. The manager may revise its policies and procedures if it provides the IRC with a written description of any significant changes for the IRC's review and input before implementing the revisions.

If an unanticipated conflict of interest matter arises for which the manager does not have an existing written policy and procedure, the manager must establish a written policy and procedure for that matter and bring the proposed policy and procedure to the IRC for its review and input at the same time as the conflict of interest matter is referred to the IRC.

A manager that manages more than one investment fund may establish policies and procedures for an action or category of actions for all of the investment funds it manages. Alternatively, the manager may establish separate policies and procedures for the action or category of actions for each of its investment funds, or groups of its investment funds.

Smaller investment fund families will require fewer written policies and procedures than large fund complexes that may have related-party conflicts as well as pure business conflicts (i.e. conflicts of interest as a result of affiliations with other financial service firms).

Manager's Record Keeping

The manager must also maintain a record of any activity that is subject to the review of the IRC, including minutes of the manager's meetings, a copy of its policies and procedures and copies of any materials, including any written reports, provided to the IRC. The manager is expected to keep records of any inter-fund trading, transactions in securities of a related issuer, or purchase of securities underwritten by related underwriters, for which the manager has sought the approval of the IRC.

A manager is expected to keep minutes only of any material discussions it has at meetings with the IRC or internally on matters subject to the review of the IRC.

The guidance notes indicate that the CSA do not view anything in the Instrument as preventing the IRC and manager from sharing record keeping and maintaining joint records of IRC and manager meetings.

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Manager to Provide Assistance

When a manager refers a matter to the IRC it must provide the committee with information sufficient for the IRC to properly carry out its responsibilities, including a description of the facts and circumstances and the manager's proposed course of action. When referring a matter to the IRC, a manager should inform the IRC whether its proposed action follows its written policies and procedures on the matter.

The manager must also provide any further information or assistance reasonably requested by the IRC and make available those senior officers who are knowledgeable about the matter to meet with the IRC or otherwise respond to the enquiries of the IRC.

A manager must not prevent or attempt to prevent the IRC, or a member of the IRC, from communicating with the securities regulatory authorities.

Orientation and Continuing Education

The manager and the IRC must provide orientation consisting of educational or informational programs that enable a new member of the IRC to understand:

a) the role of the IRC and its members collectively; and
b) his or her role as an individual member (e.g., the commitment of time and energy that is expected of them).

The manager may also provide a member of the IRC with such additional educational or informational programs as the manager considers useful or necessary, to enable the member to understand the nature and operation of the manager's and the investment fund's businesses.

The IRC may reasonably supplement the educational and informational programs provided to its members under this section, at the expense of the fund.

The guidance notes state that the CSA expect members of the IRC to regularly participate in educational or informational programs that may be useful to the members in understanding and fulfilling their duties, such as presentations, seminars or discussion groups conducted by:

a) personnel of the investment fund or manager,
b) outside experts,
c) industry groups,
d) representatives of the investment fund's various service providers, and
e) educational organizations and institutions.

IRI arranges regular continuing education sessions for IRC members.

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The Establishment and Administration of an IRC

A manager should not underestimate the amount of time that the senior management will have to spend in setting up and running an IRC.

In the first place, the senior management must review the fund's constating documents to ensure that they already have sufficient flexibility to allow the fund to set up an IRC and to comply with the new regulations. (e.g., does the fund's declaration of trust contain provisions that provide the IRC with the necessary decision making authority).

The fund manager must then prepare its own detailed written policies and procedures to be followed in specific conflict of interest matters (see "**Manager's Obligations**" above). The manager must identify and detail those matters that potentially raise conflicts of interest for that manager and which are required to be referred to the IRC for its consideration, including where the investment fund proposes to participate in transactions involving related parties. The fund manager's senior management must, therefore, consider the specific conflicts to which that manager is subject and list these in the manager's policies and procedures.

The manager must then identify, approach and recruit at least three suitable candidates to form the IRC.

Once the initial members have been identified and have agreed to serve, the manager must assist the committee to prepare the written charter for the committee and seek legal advice to ensure that the committee and the charter meet all the requirements of the Instrument.

The manager must then provide each member with an orientation course, including educational and informational programs, that enable the member to understand the fund and the nature and operation of the manager's business.

The committee must then be formally established and hold its first meeting to adopt the written charter. In addition, the IRC must establish nominating criteria for the appointment of new members.

To the extent that the manager needs to rely on any standing instruction, the standing instruction must be prepared, presented to the IRC and finalized with the IRC.

The administrative functions associated with setting up and running an IRC will include at least the following:

1. Preparing a written charter;

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2. Liaising with the fund’s legal counsel to ensure that the IRC and its written charter meet all of the requirements of the Instrument and that all of the members are independent;
3. Providing office space for meetings and for the individual members of the committee to operate from, as well as a physical mailing address and email addresses for the members so that securityholders and others can get in touch with the IRC members;
4. Scheduling meetings and issuing the notice of meetings, as and when the fund manager refers an issue to the IRC for review or when the members of the IRC request a meeting;
5. Preparing the papers for an IRC meeting, including circulating any written submissions from the manager;
6. Physically holding the IRC meetings and arranging additional hearings where the IRC members decide that they need to take advice or submissions from Outside Counsel;
7. Managing the appointment of Outside Counsel, including agreeing the scope of the engagement and the fees for that Outside Counsel and monitoring the input to ensure that the IRC actually receives the advice/services that the fund is paying for;
8. Arranging for accurate minutes of meetings and any material discussion with the manager to be prepared, approved by the IRC and retained;
9. Assisting the IRC to prepare and deliver its recommendations, suggestions, approvals or rejections and to produce any written reports;
10. Dealing with any queries raised by an IRC member;
11. Monitoring the staggered terms of office of each member, dealing with any re-appointments or new appointments required on the expiry of a term, and monitoring the 6 year limit on terms of office;
12. Searching for and recruiting appropriate replacements for any IRC members who leave the committee;
13. Providing orientation, education and informational programs for any new members of the IRC;
14. Dealing with any media interest or enquiries in respect of any matters referred to the IRC for review;
15. Arranging appropriate insurance cover for the IRC members;
16. Ensuring that appropriate disclosures are made regarding the IRC in the fund’s prospectus and other documentation (including publishing the IRC’s annual report, decisions and recommendations and any reports that the IRC directs the manager to include);
17. Preparing periodic compliance reports which record how the manager dealt with conflict situations and describe any matters where the manager relied on a standing instruction;
18. Arranging and conducting regular “self-assessment” reviews (at least annually) in accordance with the requirements of the Instrument, including undertaking a review of the IRC’s written charter, any standing instructions, the manager’s written policies and procedures, and the manager’s compliance with any standing instructions and with any conditions that the

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IRC has imposed on the manager or a fund as part of any approvals given. The annual review must also include a consideration of the structure of the IRC (e.g. the workload of the IRC, the frequency of meetings and the quality and quantity of materials provided to it) and of the effectiveness and competency of each member of the IRC (e.g. the attendance and participation record, continuing education activities and industry knowledge of each member);

19. Preparing and submitting a written report to the manager on completion of the self-assessment annual review;
20. Arranging appropriate continuing education and orientation for the members of the IRC;
21. Ensuring that all relevant IRC documents and records are retained and filed, in accordance with the requirements of the Instrument; and
22. Arranging the payment of fees to the members of the IRC and to Outside Counsel.

A manager can choose either to operate the IRC using its internal administrative resources or have the IRC pay for administrative support.

Larger fund families may well find that they need to dedicate at least one administrative person to the IRC on a full-time basis. Where the manager uses its internal resources, it may not be able to fully charge those expenses back to the fund.

Alternatively, the IRC can outsource the administrative functions to a "secretariat" (i.e., an office and/or official(s) entrusted with administrative duties, maintaining records, and overseeing or performing secretarial duties, for the IRC).

The Instrument expressly states that is does not prevent a third party from offering IRCs for investment funds. Accordingly, to ensure the complete independence of the IRC, the IRC should outsource the administration of the committee to a professional provider of independent review committee services, such as Independent Review Inc.

The Overall Cost of Setting Up and Running an IRC

The costs of operating an IRC include the following:

1) Management time and legal costs for set up of the IRC, selection of IRC members, creation of a conflict of interest policy and procedures manual and the IRC written charter;
2) IRC member fees;
3) "Search" fees where external selection of candidates is required;
4) Costs of setting up and running orientation and continuing education programs for IRC members;
5) Insurance premiums;
6) Fees for Outside Counsel where requested by the IRC; and

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7) Administration time and costs to run the IRC and maintain minutes and records (this is an internal cost if the fund manager runs the fund's IRC).

The regulators have indicated that they think smaller fund families will have to pay around $50,000 to $250,000 per annum to run an IRC. Larger fund families may find that the total cost exceeds $250,000 per annum.

It is important to note that, following the manager's setting of the initial compensation and expenses of the IRC, the IRC has the sole authority for determining the compensation and proper expenses of its members. However, the Instrument requires the IRC to set "reasonable" compensation and proper expenses for its members.

The IRC must consider the manager's recommendations, if any, when setting its compensation and expenses and the IRC's most recent previous assessment of its compensation (as part of the regular "self-assessment" process). Among the factors the IRC and manager should consider when determining the appropriate level of compensation are the following:

a) the number, nature and complexity of the investment funds and the fund families for which the IRC acts;
b) the nature and extent of the workload of each member of the IRC, including the commitment of time and energy that is expected from each member;
c) industry best practices, including industry averages and surveys on IRC compensation; and
d) the best interests of the investment fund.

The IRC may also engage independent legal counsel and other advisors (e.g. industry experts) to help the members deal with issues beyond the level of their expertise or to understand different practices among investment funds, at the expense of the fund.

The fund must pay from the assets of its fund all reasonable costs and expenses reasonably incurred in the compliance with the Instrument. The manager may reimburse the fund for any of those costs.

The manager must ensure that the costs associated with the IRC have been allocated on an equitable and reasonable basis among the investment funds for which the IRC acts (e.g., based on which funds use the IRC the most). Where the manager does reimburse a fund for any of the costs associated with the IRC, this must be disclosed in the prospectus of the relevant fund. No costs that the manager or the fund would ordinarily incur in the operation of the fund without the presence of the IRC (e.g., rent) may be charged to the fund.

Among the costs that may be charged to the fund are the following:

a) the compensation payable to the members of the IRC;

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b) the proper expenses payable to the members of the IRC (including the costs of travel, communications and buying separate insurance coverage);
c) the compensation and expenses payable to any independent counsel and other advisers employed by the IRC;
d) the reasonable fees and expenses payable by the committee to establish an independent “secretariat” for the IRC;
e) the costs of any programmes for the orientation and continuing education of the members of the IRC; and
f) the costs and expenses associated with any special meeting of securityholders called by the manager to remove a member or members of the IRC.

Potential Liabilities, Insurance and Indemnification

The Instrument provides that an investment fund and/or the manager can indemnify the members of the IRC in certain circumstances. The wording in the Instrument mirrors the provisions in the *Canada Business Corporations Act* and other corporate statutes permitting or requiring a corporation to indemnify directors and officers.

The investment fund and manager may indemnify a member of an IRC against all costs, charges and expenses, including an amount paid to settle an action or satisfy a judgment, reasonably incurred by the person in respect of any civil, criminal, administrative, investigative or other proceeding in which the member is involved because of being or having been a member of an IRC. The investment fund and manager may also advance moneys to a member of an IRC for the costs, charges and expenses of defending any such proceeding.

For these purposes, the term “member” includes a former member of an IRC, and the heirs, executors, administrators or other legal representatives of the estate of such person.

The investment fund must indemnify a member of an IRC who has been sued and has successfully defended the action provided that:

a) the IRC member must have acted in a manner consistent with his or her fiduciary duty (i.e., so long as they act honestly and in good faith, with a view to the best interest of the investment fund) with respect to the action or matter for which the IRC member is seeking the indemnification; and
b) the IRC member must have had reasonable grounds for believing that his or her conduct was lawful.

If member of an IRC does not defend an action successfully, the investment fund and manager may still indemnify the member, provided that the two conditions set out in sub-paragraphs a) and b) above are both met.

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It is open to members of an IRC to negotiate contractual indemnities with the manager and the investment fund provided the extent of the protection is permissible under the Instrument.

The investment fund and the manager can also purchase and maintain insurance coverage for the members of the IRC (on reasonable commercial terms) against any liability incurred by the member in his or her capacity as a member of the IRC.

The CSA have published a letter of advice from Davies Ward Phillips & Vineberg LLP to the Ontario Securities Commission on the liability to which a member of an IRC may be exposed under the Instrument. This letter states:

"We have concluded that an IRC Member's exposure to liability in connection with the responsibilities mandated in the [Instrument] is limited, when compared with the exposure to liability of a Corporate Director. In addition, the protection available to an IRC Member under the [Instrument] with respect to his or her discharge of those responsibilities is no less than that available to a Corporate Director…………

The liability to which Corporate Directors are subject results in part from the fact that they have overall responsibility for the management of the business and affairs of the corporation. The same is, of course, not true of IRC Members. It is the Manager that is responsible for the management of the Fund. The IRC has responsibility to review and provide either a recommendation or approval on certain very specific matters. The IRC is in no way the "directing mind" of the Fund, as a board of directors is of a corporation. Accordingly, there is a much more restricted range of matters for which the IRC Members could be held to be accountable solely as a result of performing their responsibilities as IRC Members as prescribed in the [Instrument]. Of course, if the IRC agrees with [the] Manager to accept additional responsibilities, the members of the IRC may be exposed to additional liabilities arising from those responsibilities….."

The Instrument thus limits the potential liability of IRC members by clearly defining and limiting the role of an IRC and each member's standard of care. The role of the members of the IRC is similar to corporate directors, though with a much more limited mandate, and any defences available to corporate directors should also be available to IRC members. Since IRCs have duties and responsibilities that are far less onerous than that of corporate boards, their exposure to litigation risk should be lower.

However, the members of an IRC should consider obtaining standalone insurance coverage. Such coverage would operate where an indemnity from the fund/manager is not available, either temporarily (e.g., the fund's assets have been frozen by the regulators or the courts) or permanently (e.g., the fund/manager is insolvent). Standalone coverage will have separate aggregate limits from the limits in the manager's D&O policies (which the IRC members will share with the manager's

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directors and officers) and can also apply even where the manager's insurance policy has been cancelled or voided.

Members of an IRC should also note that an IRC is designated as a market participant in Ontario, which makes the IRC members subject to the review and sanction powers of the OSC.

Next Steps

For assistance with the selection of members, the appointment of members, the establishment of an IRC, the day-to-day running of an IRC, the provision of orientation, continuing education and other informational programmes for IRC members, or for any further information on IRCs, please do not hesitate to contact us:

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