

1.1.2 CSA Staff Notice 81-317 - Frequently Asked Questions on National Instrument 81-107 Independent Review Committee for Investment Funds

CANADIAN SECURITIES ADMINISTRATORS
STAFF NOTICE 81-317

FREQUENTLY ASKED QUESTIONS ON
NATIONAL INSTRUMENT 81-107
INDEPENDENT REVIEW COMMITTEE FOR INVESTMENT FUNDS

Background

On November 1, 2006, National Instrument 81-107 *Independent Review Committee for Investment Funds* (NI 81-107 or the Instrument) came into force¹. To assist issuers in complying with NI 81-107, we have compiled a list of frequently asked questions (FAQs) and staff's responses to those questions.

FAQs

After reviewing NI 81-107, some readers have raised questions regarding its application and interpretation. This list of FAQs is not exhaustive, but broadly reflects the types of inquiries we have received.

We have divided the FAQs into two categories:

- A. application and transition issues, and
- B. specific questions on sections of the Instrument.

A. Application and Transition Issues

Transition Period

A-1 **Q.** Section 8.2 of the Instrument gives investment funds up to November 1, 2007 to comply with the Instrument. Does this transition period apply only to investment funds in existence on November 1, 2006?

A. No, the transition period applies to all investment funds. Investment funds established after November 1, 2006 may take advantage of the transition period. The transition period expires on November 1, 2007, at which time all investment funds must comply with the Instrument.

An investment fund established after November 1, 2007 must have an independent review committee (IRC) before its prospectus is receipted in accordance with section 3.1. Before the investment fund accepts any purchase order for securities, it must comply with the rest of the Instrument (please see A-2).

A-2 **Q.** What must a manager do during the transition period?

A. Subsection 8.2(2) of the Instrument requires the manager to appoint the first members of the IRC by May 1, 2007. By November 1, 2007, all investment funds must comply with the rest of the Instrument.

The Instrument requires a manager to establish policies and procedures on conflict of interest matters in accordance with section 2.2 and to refer these conflict of interest matters to the IRC for its review as set out in section 5.1 before taking any action. A manager may want to use the transition period to satisfy these requirements for any conflict of interest matter inherent or necessary in the operation of the fund to be ready to comply on November 1, 2007.

The six month period for the appointment of IRC members, and the one year transition period for the Instrument, is intended to provide sufficient time for the manager and IRC to comply with the Instrument. This includes (among other things): the IRC adopting its charter; reviewing the manager's policies and procedures; and reviewing (once referred by the manager) any conflict of interest matters anticipated to exist on November 1, 2007.

A-3 **Q.** During the transition period, is an investment fund required to amend an existing prospectus to comply with the new prospectus disclosure requirements introduced in the consequential amendments to the Instrument?

¹ In Québec, NI 81-107 came into force November 15, 2006.

A. No. Commentary 7 to section 8.2 of the Instrument indicates an investment fund may incorporate the new disclosure in its first annual prospectus renewal and continuous disclosure filing after the transition period expires. If a manager provides notice under subsection 8.2(4) that it intends to comply with the Instrument before November 1, 2007, the investment fund must incorporate the new disclosure in its next annual prospectus renewal and next interim or annual continuous disclosure filing following the notification.

A-4 **Q.** May the new exemptions introduced in Part 4 and Part 5 of National Instrument 81-102 *Mutual Funds* (NI 81-102) be relied upon during the transition period?

A. The changes made to Part 4 and Part 5 of NI 81-102 may only be relied upon if there is 'complete compliance' with the Instrument (please see A-8). Although the consequential amendments to NI 81-102 came into force November 1, 2006, the intention was that the new exemptions would apply only when the manager and investment fund have fully complied with the Instrument, which may not be the case during the transition period. An investment fund that provides notice under subsection 8.2(4) that it intends to comply with the Instrument before the transition period expires, may rely on the exemptions in Part 4 and Part 5 of NI 81-102 at the time they provide this notice.

Existing Exemptions, Waivers and Approvals

A-5 **Q.** Section 7.2 of the Instrument says that all existing exemptions, waivers and approvals that deal with matters regulated by the Instrument will expire November 1, 2007. Does section 7.2 capture all exemptions, waivers and approvals dealing with conflict of interest matters, or does this section apply only to existing relief that falls into a new exemption under either the Instrument or NI 81-102?

A. Section 7.2 captures all exemptions, waivers and approvals that deal with conflict of interest matters, regardless of whether the relief specifically is covered by a new exemption in either NI 81-107 or NI 81-102. Accordingly, all existing exemptions, waivers and approvals that deal with matters regulated by the Instrument will expire on November 1, 2007.

A-6 **Q.** What happens to existing relief expiring on November 1, 2007, for which there will be no equivalent exemption in either NI 81-107 or NI 81-102?

A. We recognize that there will be some exemptions, waivers and approvals on conflict of interest matters that do not have a corresponding exemption under the Instrument or NI 81-102. If the investment fund still requires that exemption, waiver or approval, the fund will need to apply for the exemptive relief not otherwise addressed in NI 81-107 or NI 81-102. Filers will want to consider what conditions may be appropriate for that relief since the IRC will, under the Instrument, review all conflict of interest matters. We encourage you to make these applications early.

A-7 **Q.** During the transition period, can a manager or investment fund continue to rely on existing exemptions, waivers and approvals even if the 'sunset provision' states that the relief expires with the coming into force of an instrument dealing with the matter?

A. Yes. Section 7.2 permits a manager and investment fund to continue to rely on any exemption, waiver and approval that deals with matters regulated by NI 81-107 until November 1, 2007, despite any 'sunset provision' in any particular relief.

Exemptions and Applications during the Transition Period

A-8 **Q.** During the transition period, can an application be made for exemptive relief of the type the CSA has previously granted for conflict of interest matters that the Instrument regulates? Would the CSA grant new exemptive relief before November 1, 2007, equivalent to a new exemption in the Instrument or NI 81-102?

A. We will continue to consider requests for exemptive relief on conflict of interest matters. For similar relief to that granted in the past, we will generally consider imposing terms and conditions that are the same as in the past, including a 'sunset provision' that the relief will expire on November 1, 2007.

Generally, we would not expect to recommend a new type of exemptive relief on a conflict of interest matter before the transition period expires just because that exemption is included in the Instrument or NI 81-102. This is because the new exemptions in the Instrument and NI 81-102 anticipate that the manager and investment fund will be fully compliant with the Instrument, which may not be the case for a fund that requests relief during the transition period.

Early Compliance with the Instrument

A-9 **Q.** Commentary 3 to section 8.2 of the Instrument states that a manager may not, under subsection 8.2(4), notify the regulator that the manager intends to comply with the Instrument before the transition period expires unless there is “complete compliance” with the Instrument. What is meant by “complete compliance” with the Instrument?

A. The one year transition period (to November 1, 2007) is intended to provide managers and IRCs with sufficient time to comply with the Instrument (please see A-2 above). If a manager decides it wants to have its IRC in operation before November 1, 2007, the manager must give us notice under subsection 8.2(4). Once a manager notifies the regulator under this section, the manager and IRC must comply with all parts of the Instrument.

A-10 **Q.** If a manager gives notice under subsection 8.2(4) of the Instrument of its intention to comply with the Instrument before November 1, 2007, is the investment fund required to amend its existing prospectus to comply with the new IRC disclosure requirements?

A. No, commentary 7 to section 8.2 of the Instrument says an investment fund may incorporate the new disclosure requirements in its next annual prospectus renewal and continuous disclosure filing after the transition period expires (please see A-3 above).

However, if a manager intends to rely on an exemption in the Instrument or NI 81-102 that requires prospectus disclosure (or if the IRC requires prospectus disclosure as part of its approval), the investment fund must amend its prospectus to add the requisite disclosure before relying on the exemption.

A-11 **Q.** If a manager gives notice under subsection 8.2(4), when must the IRC complete its first IRC report and subsequent IRC reports to securityholders under section 4.4?

A. Subsection 8.2(3) of the Instrument states that the IRC must complete its first report by the 120th day after the end of the first financial year of the investment fund after the Instrument applies.

Example: An investment fund has a December 31 financial year end. If the manager gave notice under subsection 8.2(4) on December 1, 2006, the IRC must complete its first report by April 29, 2007. If the manager gives notice anytime between January 1, 2007 and October 31, 2007, the IRC must complete its first report by April 29, 2008. If no notice is given, the transition period for the investment fund will expire November 1, 2007, and the IRC must complete its first report April 29, 2008.

Following the first IRC report, the IRC must complete subsequent reports for each financial year of the investment fund no later than the date the investment fund files its annual financial statements.

Regardless of the timing of the first IRC report to securityholders, the Instrument requires the IRC to carry out all other functions under the Instrument, including its regular assessments under section 4.2 of the Instrument, as soon as the Instrument applies.

B. Specific Questions on Sections of the Instrument

Part 1 – Definitions and Application

B-1 **Q.** What are the types of conflicts of interest facing “an entity related to the manager” that are intended to be caught in the definition “conflict of interest matter” in paragraph 1.2(a) of the Instrument?

A. It was not intended that all sub-advisor conflicts of interest be referred to the IRC. The intention of paragraph 1.2(a) was to bring to the attention of the IRC those types of conflicts faced by a service provider when managing/providing services to an investment fund that raise the question of whether the decision being made is in the best interests of the fund. Examples of potential conflict of interest matters under paragraph 1.2(a) are a sub-advisor’s allocation of securities among a family of investment funds; and soft dollar arrangements with dealers with whom the sub-advisor places portfolio transactions for the investment fund.

Part 2 – Functions of the Manager

B-2 **Q.** Section 2.2 of the Instrument requires the manager to establish policies and procedures it must follow for a particular conflict of interest matter and to refer those policies and procedures to the IRC for its review and input before proceeding with a conflict of interest matter. If the conflict of interest (as defined in section 1.2) is that of the advisor/sub-advisor, which policies and procedures should be brought to the IRC, those of the manager or the advisor or sub-advisor?

A. The Instrument requires the manager to refer its own policies and procedures to the IRC. To fulfil a manager's standard of care under securities legislation, a manager must have sufficient policies and procedures to monitor how an advisor/sub-advisor handles its own conflicts of interest when providing services to the investment fund.

Part 3 – Independent Review Committee

B-3 Q. Paragraph 3.10(2)(d) of the Instrument specifies that an individual ceases to be a member of the IRC if a majority of the securityholders of the investment fund vote to remove the individual at a special meeting called for that purpose by the manager. Does 'majority' mean "50% +1", or does it mean 'majority' as set out in subsection 5.2(1) of NI 81-102?

A. The intention of paragraph 3.10(2)(d) was to require the same 'majority' for securityholder votes as required in subsection 5.2(1) of NI 81-102, being a "majority of the votes cast at a meeting of the securityholders". We will revise this section to provide greater clarity when we next propose amendments to the Instrument.

B-4 Q. Section 3.14 of the Instrument sets out the indemnification and insurance an investment fund and manager may provide to a member of an IRC. May an entity related to the manager (as defined in section 1.3), including the parent corporation of the manager, indemnify and/or insure members of the IRC?

A. Yes. Section 3.14 does not preclude IRC members from receiving an indemnity and/or insurance from entities other than the investment fund and manager, including an entity related to the manager.

Part 5 – Manager to Refer Conflict of Interest Matters to IRC

B-5 Q. Subsection 5.2(1) of the Instrument sets out the conflict of interest matters that require IRC approval for the manager to proceed. Paragraph 5.2(1)(a) refers to both inter-fund trades captured by section 6.1 of the Instrument and transactions described in subsection 4.2(1) of NI 81-102. Does this mean all transactions described in subsection 4.2(1) of NI 81-102 require IRC approval to proceed?

A. No, the intention of subsection 5.2(1) was to capture only those conflict of interest matters that are subject to a new exemption under the Instrument or NI 81-102. Accordingly, paragraph 5.2(1)(a) was only intended to refer to inter-fund trades captured by section 6.1 of the Instrument and/or subsection 4.2(1) of NI 81-102. We will revise this section to provide greater clarity when we next propose amendments to the Instrument.

B-6 Q. Paragraph 5.4(2)(a) of the Instrument requires the manager, with respect to each instance it acted in reliance on a standing instruction from the IRC, to provide a written report to the IRC at the time of the IRC's regular assessment under section 4.2. Can 'each instance' be a 'category of instances' for trades or conflict of interest matters that arise repeatedly and are all handled the same way?

A. Yes. The Instrument does not prevent a manager from interpreting, in circumstances where there are recurring transactions or matters, 'each instance' to mean a 'category of instances'. For example, if a manager has received a standing instruction with respect to a category of trades, the manager does not have to provide to the IRC details of each transaction within the category.

However, to comply with this reporting requirement, a manager would need to provide the IRC with enough detail (for example, the number of instances/trades) in the report for the IRC to be able to determine whether the manager has fulfilled any terms of the IRC's standing instruction. Also, paragraph 2.4(1)(c) requires the manager to provide more detailed information to the IRC on request. We will revise this section to provide greater clarity when we next propose amendments to the Instrument.

Part 6 – Exempted Transactions

B-7 Q. The inter-fund trading exemption in section 6.1 of the Instrument requires that trades of exchange-traded securities be at 'closing sale price'. Would the CSA consider applications for exemptive relief to permit inter-fund trades of exchange-traded securities to occur throughout the trading day, at the 'last sale price' immediately prior to the time of the inter-fund trade?

A. Yes, upon appropriate terms and conditions. The conditions in section 6.1 are intended to minimize the possibility that the price of the security is being manipulated. Some additional conditions might be necessary for trades made during the trading day. We intend to revise the section to permit 'last sale price' when we next propose amendments to the Instrument.

B-8 **Q.** In addition to cross-trades of securities between investment funds, does the inter-fund trading exemption in section 6.1 apply to in-kind transactions between investment funds (i.e., the settlement of a purchase or redemption of units of an investment fund with the securities of an issuer)?

A. Yes, section 6.1 applies to in-kind transactions between investment funds.

Section 6.1 applies to an investment fund's purchase of a security from, or sale of a security to, another investment fund managed by the same manager or an affiliate of the manager, provided the investment funds are subject to NI 81-107. Mutual fund fund-of-fund transactions made in accordance with section 2.5 of NI 81-102 must also comply with the requirements in section 6.1.

The inter-fund trading exemption in section 6.1 does not apply to purchases or sales of securities of an issuer between an investment fund and managed account or pooled fund, nor between managed accounts and pooled funds. We will continue to consider requests for exemptive relief for these types of transactions on the same terms and conditions granted previously.

Questions

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