

# Investors beware

*Proposals for regulating the mutual fund industry appear to protect investors. They actually offer a false sense of security.*

**By Glorianne Stromberg**



THE CANADIAN SECURITIES ADMINISTRATORS (CSA) HAS published its long-awaited proposals for a new regulatory regime governing mutual funds and their managers. The proposals address recommendations made in a report I wrote for the CSA in 1995, entitled *Regulatory Strategies for the Mid-'90s: Recommendations for Regulating Investment Funds in Canada*. The CSA closely discussed its proposals with the mutual fund industry, which supports them according to The Investment Funds Institute of Canada.

The CSA proposals appear to reflect the main components of my 1995 report. The CSA calls for the registration of mutual fund managers with appropriate conditions of registration, governance standards with independent bodies, better regulation of product and product distribution, improved disclosure and investor rights as well as enhanced regulatory compliance and enforcement.

But, as in so many things, the devil is in the details. In this case, the details raise concern about whether investors will be better protected, and what impact some of the proposals will have on the integrity and operation of capital markets. The two major areas of concern relate to proposals for a governance agency and to repealing, or otherwise making inoperative, the prohibitions in securities legislation against self-dealing. The two are linked.

The CSA's description of a governance agency sounds ideal, but is it? They describe it as "a group that is independent of the mutual fund manager ... [that] will oversee that manager's management of its mutual funds ... [and will] owe its allegiance to investors and ensure that the mutual fund manager acts in the best interests of investors." Elsewhere, the CSA states the agency will have "ultimate power and responsibility in respect of the governance of an organization."

What is troubling is the transfer of the manager's obligation to act in the best interests of investors in its managed funds to an appointed body of individu-

als who are neither fish nor fowl. These individuals are not on the manager's board of directors or the governing body of the mutual fund—unless the mutual fund happens to be a corporation. They float above the manager and its managed funds.

Yet these individuals—who have no economic interest at stake—are vested with the ultimate responsibility of ensuring that the manager acts in the best interests of the investors in its managed funds. This leaves managers free to focus on their own interests. The reality is that no matter how able or how diligent members of the governance agency may be, the task set out for them is well-nigh impossible to fulfil. This does not bode well for investors who, by the way, will pay for the cost of this agency with no offset in management fees and other expenses charged to the funds.

Another troubling aspect of the proposals is that the manager's funds will be allowed to engage in related-party and self-dealing transactions that are currently prohibited, if a governance agency authorizes them. Agencies may be pressured to authorize these transactions with little or no evidence to determine whether they are in the best interests of investors.

Regulators and the industry have apparently struck a deal that effectively off-loads their respective responsibilities onto the unsuspecting shoulders of governance agencies, while lulling investors into a false sense of security that their interests are protected.

It is too early to say what implications the proposals have for pension plans. But the matter should be watched. If the proposals are implemented, defined contribution plan sponsors will want to take a closer look at the appropriateness of offering mutual funds. They should also carefully monitor the activities of mutual fund managers with respect to related-party transactions. In the case of defined benefit plans, the proposals may encourage money managers to seek amendments to pension legislation to remove the prohibitions on related-party transactions. **BC**

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