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Comment Letter on Canadian Concept Proposal on Mutual Funds, June 2002

June 7, 2002

Canadian Securities Administrators
John Stevens, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8

Denise Brousseau, Secretary
Commission des Valeurs Mobiliéres du Québec
800 Victoria Square, Stock Exchange Tower
P.O. Box 246, 22nd Floor
Montreal, Quebec H47 1G3

Dear Mr. Stevens and Ms. Brousseau:

The Investment Company Institute appreciates the opportunity to comment on the Canadian Securities Administrators' recent concept proposal on the regulation of mutual funds and their managers (the Proposal).[1] The Institute is the national association of the U.S. investment company industry. Our membership includes 8,984 open-end investment companies, 504 closed-end investment companies, and 6 sponsors of unit investment trusts. Our open-end investment company members have assets in excess of $6.925 trillion, accounting for approximately 95 percent of total industry assets, and over 88.6 million individual shareholders. A number of our members manage Canadian funds through their affiliates based in Canada.

We are writing to comment on one specific aspect of the Proposal: the application of minimum capital requirements to fund managers. The Proposal states that fund managers will be required to meet minimum capital requirements, but notes that the CSA has not yet selected a means of calculating minimum capital amounts and seeks comment on whether a minimum capital requirement is justified.[2] It also states that the CSA is considering recommendations made by the Stromberg Report,[3] the Steering Group Report,[4] and Stephen Erlichman[5] in determining the appropriate level and calculation of minimum capital.

The Proposal gives three justifications for minimum capital requirements:

Capital will require mutual fund managers to maintain adequate financial resources to meet their business commitments, including providing quality staff, equipment, systems and services to support the assets of fund investors;

Capital will ensure that mutual fund managers have the ability to satisfy any major legal claims, such as accountability for prospectus disclosure, which may be made; and

Capital will offer some protection against the risk that the mutual fund manager will collapse and not meet its liabilities.

We do not believe that these reasons justify the imposition of minimum capital requirements on fund managers at the levels being considered, particularly at the excessively high levels recommended by the Stromberg Report and Steering Group Report.[6] In our view, other aspects of mutual fund regulation and the use of insurance are far more effective than minimum capital requirements as a means of managing operational risk for fund managers.

Our comments below first explain why we do not believe that capital requirements are needed for mutual fund managers. We then explain why we believe that the proposed capital requirements would have anti-competitive effects in the Canadian mutual fund industry.

A. Capital Requirements are Not Needed for Mutual Fund Managers

In contrast to the business of banking, the business of managing assets does not require large amounts of capital to protect investors. We agree that fund managers should be encouraged to provide quality staff, equipment, systems, and services to support their management of fund assets, but it is unclear to us how capital requirements would be an effective means to achieve this goal.[7] We also agree that fund managers generally should be able to meet their current liabilities and satisfy any major legal claims, particularly those of fund shareholders. However, in our view, a strong regulatory regime, effective securities regulator, the strict segregation of fund assets from the fund manager, and the use of appropriate insurance all serve to minimize the risk of shareholder losses[8] better than a capital requirement.

Moreover, the three traditional economic arguments in favor of imposing minimum capital requirements—1) protecting against "moral hazard", 2) protecting against systemic risk, and 3) protecting consumers—are not persuasive in the case of fund managers.[9] "Moral hazard" can occur where there is some sort of government protection against loss, such as deposit insurance. This is not the case with mutual funds in either Canada or the U.S., since they are not insured by the government. Systemic risk likewise is not a significant concern in this context. The failure of a mutual fund manager would not have risk externalities, as in the case of a bank failure, as it is extremely unlikely that such an event would, by itself, raise concerns about the stability of securities markets or lead to financial stress at other financial institutions. Finally, while capital also can be used to protect consumers, in our view it is less effective and efficient than other methods. For example, operational risk in asset management is highly idiosyncratic and risk events are not likely to be correlated across institutions. As a result, operational risks in asset management are insurable by private insurance companies to a greater extent than in some other financial services industries, and fund managers often use bonding and insurance to cover operational risk.[10] Moreover, provisions that address the operations of mutual funds (such as the strict segregation of assets and the valuation of fund portfolios), provide for annual audit by independent accountants, regulate conflicts of interest, and establish investor compensation schemes to protect against fraud by employees of mutual funds all help mitigate against a fund manager's operational risk. Indeed, two concepts in the Proposal itself—an effective system of fund governance and an enhanced inspection role for securities regulators—would provide for more protection against a fund manager's operational risks than a capital requirement.

For all of these reasons, we believe that an approach coupling effective regulation of mutual fund operations with private insurance and its resulting private market monitoring and incentives should eliminate the need for a regulatory capital requirement for mutual fund managers, or at least should significantly reduce the amount of capital required to be maintained. Accordingly, Canada should not apply to mutual fund managers capital requirements at the levels being considered. While requirements of this type may be appropriate for other financial institutions, such as banks, they are neither necessary nor appropriate for mutual fund managers.

It may be worth noting that this same conclusion has been reached in other forums that have recently studied the application of bank-style capital requirements to mutual fund managers. In October 2001, the International Investment Funds Association (IIFA) issued a statement stressing the inappropriateness of seeking to apply to investment funds capital requirements designed for other financial institutions, particularly banks. A copy of the statement, which was based on the recommendations of a working party that considered the issues over a year, is attached. In 1999, the U.S. Congress explicitly considered but rejected the imposition of capital requirements on bank holding companies based on activities of registered investment adviser affiliates.[11] As a result, the U.S. Federal Reserve Board cannot impose capital requirements on an affiliate registered as an investment adviser with the U.S. SEC or any state, or take into account the activities, operations, or investments of an affiliated mutual fund in establishing or assessing bank holding company capital or capital adequacy rules.[12]

B. The Capital Requirements Under Consideration Will Have Discriminatory Effects

We believe the capital requirements under consideration will have discriminatory effects in two respects. First, the Stromberg, Steering Committee, and Erlichman recommendations would set capital requirements for mutual fund managers based solely on assets under management. By not distinguishing between firms whose activities may present higher or lower risks to consumers than other firms, the proposals would create no incentives for mutual fund managers to avoid, manage or mitigate risks. Accordingly, relying on capital requirements to protect consumers from the risks associated with mutual fund management necessarily discriminates against lower risk providers of mutual fund management.

Second, the imposition of high capital requirements on mutual fund managers will create barriers to entry for niche mutual fund management firms in Canada. Mutual fund management companies that are part of large financial institutions such as banks already are indirectly subject to capital requirements. Because these institutions are able to allocate capital across several lines of business, they likely will not be required to hold any additional capital if any of the recommended mutual fund management capital measurements are adopted. On the other hand, smaller, niche providers of mutual fund management in Canada may have to raise

additional capital to continue in, or enter, the mutual funds business in Canada. Highly successful asset management industries around the world have benefited from the presence of smaller, independent investment management firms. We believe it would be unfortunate if Canada were to impose a high capital requirement at this time that would prevent firms of this type from participating in Canada's mutual fund industry.

* * *

We appreciate the opportunity to comment on this important Proposal. If we can provide any other information or if you would like to discuss further any of the issues raised in this letter, please call me at (202) 326-5826 or Bob Grohowski at (202) 371-5430.

Very truly yours,

Mary S. Podesta
Senior Counsel

Attachment

ENDNOTES

[1] Concept Proposal 81-402, "Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers" (March 1, 2002).

[2] Proposal at 31-32; Issue for Comment No. 31.

[3] Regulatory Strategies for the Mid-'90s: Recommendations for Regulating Investment Funds in Canada, prepared by Glorianne Stromberg for the Canadian Securities Administrators, January 1995. The Stromberg Report recommends that capital should be set at $1,000,000 and should increase as fund assets increase according to the following scale:

- Less than $100 million - $1,000,000
- $100 million to $200 million - 1.00% up to $2,000,000
- $200 million to $1 billion - 0.25% up to $4,000,000
- $1 billion to $5 billion - 0.10% up to $8,000,000
- $5 billion and over - 0.05% over $8,000,000.

[4] The Stromberg Report: An Industry Perspective, prepared by the Investment Funds Steering Group for the Canadian Securities Administrators, November 1996. The Steering Group recommended a formula that combines a minimum level of working capital and a minimum level of net worth based on net assets under management. The minimum level of net worth would consist of a set minimum amount (for example $1 million), plus an additional amount that varies depending on the net assets under management:

- $100 million to $500 million - an additional 50 basis points of such net assets
- $500 million to $2 billion - an additional 35 basis points of such net assets;
- $2 billion to $5 billion - an additional 25 basis points of such net assets; and
- in excess of $5 billion - an additional 10 basis points of such net assets.

[5] Making it Mutual: Aligning the Interests of Investors and Managers— Recommendations for a Mutual Fund Governance Regime for Canada, prepared for the Canadian Securities Administrators by Stephen I. Erlichman, June 2000. Mr. Erlichman recommended that the CSA review other recommendations, including the Australian Law Reform Commission's recommendation that capital should be set at 5 percent of the value of the assets of all mutual funds managed by the manager, subject to a minimum of $100,000 and a maximum of $5,000,000.

[6] Based on our calculations, the minimum capital for a fund manager with $10 billion in assets under management, which would be a medium-sized manager in the current Canadian market, would be $23.75 million under the Steering Group's recommended formula and $10.5 million under the Stromberg Report's recommended formula.

[7] The Proposal does not make it clear whether the capital maintained by a fund manager would be able to be used for hard assets like equipment and systems, or whether the capital would have to be maintained as a reserve. In either case, there does not seem to be any correlation between the level of capital required to be maintained and the amount spent by a company on personnel, shareholder services, or other "soft" assets.

[8] Of course, shareholder losses in this context refer to losses suffered as a result of liabilities incurred by a fund manager, not losses suffered as a result of poor performance of a fund in which a shareholder invests.

[9] For a discussion of these arguments, see Herring, Richard J. and Litan, Robert E., Financial Regulation in the Global Economy, Brookings Institution (1995).

[10] Indeed, fund managers may be required to do so in Canada in accordance with the Proposal. See Proposal at 33 (discussing the imposition of minimum bonding and insurance requirements).

[11] Asset managers that are registered with the US SEC as investment advisers are not subject to any capital requirements in the United States.

[12] Section 5(c)(A)(3) of the Bank Holding Company Act of 1956. To be fair, these are not the only forums in which this issue has been taken up. The Basel Committee on Banking Supervision and the European Commission both are currently undertaking consultative processes with respect to capital adequacy, although neither has concluded. In addition, the recent amendments to the UCITS Directive in Europe include provisions imposing capital requirements on management companies of UCITS funds. However, those amendments specifically require the European Commission to review and report on the new capital requirements no later than February 13, 2005, taking into account the work of the Basel Committee, European Commission, and other international forums on these issues.
