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Catalyst for Change: Mutual Funds in Canada

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CATALYST FOR CHANGE: MUTUAL FUNDS IN CANADA

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The growth of the mutual funds industry in the last thirty years has been spectacular, both in the United States and in Canada. Although a superficial comparison of the industries in these countries might indicate a high degree of similarity, the industry in Canada operates within a surprisingly different framework, both from the standpoint of regulation and taxation. The effect of this framework on fund behavior, however, is not easily predictable. This in-depth examination of the Canadian mutual funds industry describes the framework within which that industry operates and the resulting effects on fund behavior. In doing so, it provides the basis for a comparison between the mutual funds industry of Canada and that of the United States which, at least by inference, suggests that certain patterns of fund behavior may be endemic to the industry, whether it be Canadian or American, and, accordingly, in regulating that industry that there are certain factors worthy of consideration, no matter where in North America the industry is operating.

PROFILE IN LAW

INTRODUCTION: THE LACK OF A REGULATORY SCHEME

Canadian mutual funds have served as a catalyst in the dramatic change in the role of financial institutions during which many banks,[1] life in-

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[1] Concerned with their legal right to sell investment advice, only three of the nine Canadian banks have entered into mutual fund relations. Two of them, however, rank among the five largest banks holding 90 percent of that industry's assets. Furthermore, it is worth noting that the two, the Toronto-Dominion Bank and the Royal Bank of

surance[2] and trust companies[3] have become financial conglomerates. The newest, and still the smallest in asset size, of the institutional investors, the mutual fund has aided in bringing this departure from single-line functions and, as a result, has spurred competition between different classes of institutional investors.

Each type of institutional investor seems to have fashioned the mutual fund device to suit a particular end. Although the investment fund of

Canada, have interests in the Investors Group which controls more than a third of the nation's mutual fund assets.

Primarily, the two banks serve as sales outlets through their many branch offices. In this regard, the Toronto-Dominion takes 8.5 percent commission of fund shares sold while the Royal Bank receives nothing. However, the Royal Bank for a related fund, Royfund, acts as accountant, transfer agent, and custodian; and, through the management company of Investors, the Toronto-Dominion shares in compensation paid for investment advice. *See* CANADIAN COMM. ON MUTUAL FUNDS AND INVESTMENT CONTRACTS, REPORT (1969) [hereinafter referred to as MUTUAL FUND COMMITTEE REPORT].

2 THE CANADIAN LIFE INSURANCE ASS'N SUBMISSION TO THE CANADIAN COMM. ON MUTUAL FUNDS AND INVESTMENT CONTRACTS, June 1968, at 12 [hereinafter cited as LIFE INSURANCE SUBMISSION].

At that time these funds had total assets of $207 million, of which $15 million related to out-of-Canada business.

In Canada emphasis had been on pooled variable funds, where a number of policyholders participate in the investment results of the same fund. At the end of 1967, 18 of the 21 companies had each set up one pooled equity (*i.e.*, a variable fund invested primarily in common stocks) and two companies had two pooled equity funds, each for a different class of policyholders. One company did not have an equity fund.

In addition, five companies had established pooled equity funds for out-of-Canada policyholders. Ten of the 21 companies had established fixed-income pools (*i.e.*, a variable fund invested in fixed-income types of investment). Three of these companies had two fixed-income funds, one invested in bonds and the other in mortgages. Two companies had only a mortgage fund, one had only a bond fund while the remaining four combined bonds and mortgages in one fund.

Most of the companies are prepared to establish nonpooled funds for large group pension policyholders. Sixteen such funds had been established by eight companies.

3 After a period of experiment with the operation of registered retirement savings plans, several trust companies expanded their range of services to include funds in which clients wishing portfolio management could invest their money and from which they could withdraw at any time. For many years, the trust companies had provided portfolio management on an individual basis to meet the needs of larger clients and one of the objectives was to provide similar services to clients with smaller amounts of money available for investment. Here, as with funds for registered retirement savings plans, most of the trust companies organized two or more funds to provide clients with a choice of investment objectives; again as with funds for registered retirement savings plans, the equity-oriented funds have been proven most popular. Since the first major trust company investment fund was created by The Canada Trust Company in 1959, investments in the equity sections of this and other such funds have grown to over $87 million (at the end of 1967). MUTUAL FUND COMMITTEE REPORT.

a trust company may bear direct resemblance to a mutual fund, there is a substantive difference between a company's larger pooled fund operation of a retirement or pension scheme[4] and the operation of a mutual fund. The variable annuity of the life insurance company serves many ends, with some companies integrating the equity investment with the regular life endowment or term insurance and others basing cash values on investment performance.[5] Thus, in using the monies of individual investors for equity purchases, these financial institutions are using a device analogous to the mutual fund and one which is flexible enough to suit the needs of each particular institution. Like the trust company, the bank manager can wait for the customer to seek him in the normal course of events, whereas the life insurance company, like most mutual funds, must solicit customers. The trust, bank, or life insurance company can encumber the fund bought and can impede the right of share redemption based on the net asset value, the most basic characteristic of a mutual fund;[6] variable annuity growth can go into life insurance premiums and a trust company can operate equity-based retirement schemes that demand the absence of redemption for a stated period as a condition to tax deferment for the monies contributed.[7]

All financial institutions have become equity oriented. While accelerating this process, investment funds account for only a small portion of bank, trust, or life insurance assets. Thus, at the end of 1967, life insurance assets were $13 billion, with the industry's variable funds representing only 1.5 percent of the total.[8] Administered by trust companies, investment funds that could be characterized as mutual funds had assets of $87 million[9] while trusteed pension funds alone, handled by trust and life insurance companies, had assets of $7.1 billion.[10]

As an industry, banking dwarfs the mutual funds. At the end of 1968,

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4 A qualified retirement or pension scheme is one which would inhibit the right of redemption before the date of retirement; that is, monies paid into the plan would not be taxed until the due date for retirement. While in practice the individual could demand and receive monies in advance of retirement he would lose the advantage of tax deferment.

5 LIFE INSURANCE SUBMISSION 31, 32.

6 MUTUAL FUND COMMITTEE REPORT 50, 51. The distinction between sought and unsought goods is a real one. Often the consumer seeks out the bank or trust company branch manager for assistance, for investment advice. Here the consumer takes the initiative in the purchase of mutual or investment shares. This is quite different than the mutual fund or insurance salesman who knocks on doors for the purpose of making a sale.

7 *See* note 4 *supra*.

8 LIFE INSURANCE SUBMISSION 2.

9 MUTUAL FUND COMMITTEE REPORT 13.

10 *Id.* at 10, 121.

the nine banks of Canada held \$36.7 billion in assets, the five largest banks accounting for more than 90 percent of the total.[11] Any one of these five largest banks has nearly twice the total assets of all the Canadian mutual funds; total mutual fund assets at the end of 1967 were \$2.7 billion, and the largest fund complex, the Investors Group, which was partially owned by two Canadian banks, held \$915.7 million.[12]

The evolving complex of Canadian financial institutions is striving to meet, anticipate, and stimulate all types of consumer financial needs. In such a setting, the difficulty of regulating mutual funds without comparable regulation over variable annuities, investment funds or retirement funds is patent. In Canada, there is presently no comprehensive regulatory scheme for the mutual fund industry. There are no pervasive rules of conduct fashioned by a regulatory agency holding a broad grant of legislative authority.

In assessing the scope and efficacy of potential regulation, an examination of investment behavior is vital to an understanding not only of fund goals, but also of the impact of fund competition with institutional giants. Unlike a large bank or trust company, a fund offers a single-line product; the most effective avenue for fund competition and growth is performance, which depends solely on the choice of investments. To be attractive, especially in a rising market, funds must pursue ever greater returns at, what must be assumed, even greater risk.[13] It follows that fund management is not apt to embrace eagerly government regulation that restricts its freedom to engage in high risk investment and to compete effectively for capital with other larger and more diversified financial institutions. Thus, in any analysis of existing law or proposed regulatory schemes, the attitude of the regulated must be carefully

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11 The exact figure is \$36,698,817,000, based on "Statement of the Assets and Liabilities of the Chartered Banks of Canada as of December 31, 1968."

Bank	*Assets*
The Royal Bank of Canada	\$ 9.2 billion
The Canadian Imperial Bank of Commerce	\$ 8.4 billion
The Bank of Montreal	\$ 6.99 billion
The Bank of Nova Scotia	\$ 5.21 billion
The Toronto Dominion Bank	\$ 4.5 billion
La Banque Canadienne Nationale	\$ 1.5 billion
Banque Provinciale de Canada	\$759 million
Mercantile Bank of Canada	\$190 million
Bank of British Columbia	\$ 36 million

12 *See* note 1 *supra*.

13 Public acceptance of the "venture" fund and the concommitant higher level of risk has not only resulted in an increase, both in number and size, of such funds, but has also caused some conventional funds to reexamine their own investment policies. *See* MUTUAL FUND COMMITTEE REPORT 1.

weighed. Unless the law is quite specific and the agency capacity and willingness to enforce that law unambiguous, full compliance on the part of a hostile industry cannot be expected.

The existence of an unstructured regulatory scheme in a burgeoning industry whose members need a certain freedom to act set the need and the tone for a unique governmental study by the Canadian Committee on Mutual Funds and Investment Contracts. The study was initiated in late 1969 under the direction of federal and provincial securities officials. It was funded jointly by the federal government and all the provinces. The creation of the Committee resulted from the spectacular growth of open-ended mutual funds and the awareness that mutual funds were subject to a variety of legislation, most of which was not specifically tailored for them and created many difficulties in application. There was also concern with the lack of regulatory provisions designed to deal with the resulting competition by other financial institutions.[14]

The Committee report includes in-depth recommendations for an industry regulatory scheme and deals with a few matters that provide insight into what emerges as the limited role of law. Initially, the report faced the problem of specifically defining mutual funds so that a charter of rights and responsibilities could be drafted. In the context of competition for capital between financial institutions, there was ample justification for the Committee to seek a definition that would encompass any pooled fund with public participation. To do this, however, would require regulation over diverse institutions which offer varied instruments for public subscription and which have long been subject to administration by a number of specialized agencies.

Facing these considerations, the Committee defined a mutual fund in terms of the instrument being sold rather than on the basis of competition for consumer monies; a mutual fund share, however, differs from a tax-deferred retirement fund and many other kinds of variable annuities in that the fund share may be redeemed at any time at net asset value.[15] The Committee was of the opinion that, for definitional purposes, reliance on the nature of the instrument issued made the nature of the business carried on by the organization irrelevant.[16] Although this definition

[14] *Id.* at iv.

[15] The Committee Report stresses the characteristic of redemption as the distinguishing characteristic of a mutual fund. *Id.* at 115. The legal reality today, however, is quite different. There is not absolute right either to immediate redemption or to redemption in cash rather than underlying securities of the fund. This point is not fully discussed in the Committee Report.

[16] *Id.* at 114. The Committee leaves no doubt that the overriding concern in the definition of a fund is redemption: "[O]ur recommended definition . . . focuses on

would permit precision in drafting a regulatory scheme, it would also provide other financial institutions with considerable incentive when establishing their own investment funds to deviate from the redemption features of the mutual fund in order to avoid broad governmental regulation and, thereby, to gain a considerable competitive advantage. The report conceded that the definition does not mark an obvious separation between types of financial instruments; for example, it does not include variable policies of life insurance companies and the segregated funds on which they are based, even though such policies are directly competitive with mutual funds.[17]

The report recommended that, as a matter of public policy, the regulatory scheme proposed for mutual funds be adjusted to cover similar financial arrangements.[18] The report sought to isolate the elements common to mutual fund operations, to make suggestions that would give the public uniform substantive protection, and not to place mutual funds at a competitive disadvantage. The report nevertheless accepted the reality of specialized regulation; although each institution may compete for the same savings dollar, there is a core distinction which justifies continued specialized, administrative regulation. Unlike a mutual fund which is subject to generalized control by a securities commission, other financial institutions should have the uniform, substantive law separately administered; if greater disclosure is desirable for some kinds of variable annuities, the details of prospectuses and their implementation should be set by a superintendent of insurance, not by a securities commission.[19]

There are a number of difficulties with such recommendations, all of which point to the near impossibility of uniform administration. At a simplistic level, different agencies employing staffs of different quality will differ in their individual decisions. For example, there would be no advisory ruling from a securities commission that the prospectus of a life insurance company's variable annuity plan is deficient in its statement of investment policy, redemption features, and sales charges. The decision would be made by an insurance department operating within the framework of its own traditions and experience. Historically, the agencies which regulate insurance companies have had an industry orien-

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the redeemability of shares or units rather than their continuous distribution to the public." *Id.* at 115.

[17] *Id.* at 614.

[18] *Id.*

[19] *Id.* at 636. In part, for constitutional reasons (since banking is subject to exclusive federal jurisdiction) the report recommends establishment of a national sales training program that could be shaped by the banking industry. *Id.* at 624.

tation[20] and their concern has been with adequate reserves, with the capacity of the industry to meet its obligations, and with keeping the industry in a competitive position vis-a-vis other financial institutions. Their concern is not the implementation of a general standard of disclosure. Mutual funds do not share this advantage. The securities commission in any province is not in existence primarily to oversee the funds. Therefore, there is not the same opportunity to develop a community of interest in which a commission would dedicate itself to the preservation and promotion of a viable fund industry through interpretation of law and recommendations for reform.[21]

From the community of interest which develops between the agency charged with administering broad grants of power over a designated industry and the industry itself comes an exchange of confidence. The regulators and the regulated are unlikely to disclose decisions actually made, or the reasons for these decisions.[22] Formal rules and policy statements of general application are less likely to be forthcoming than ad hoc informal adjudication, which by its very nature encourages still more confidential interchange and only reinforces the cycle of secrecy.[23] There is a certain vitality in general law generally administered which is lacking in special law specially administered. Should the committee

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20 The best evidence of agencies with industry orientation can be seen in the legislation they proposed which permitted both banks and insurance companies wider activity to meet competition. *See* Bank Act, CAN. STAT. c. 87 (1967); Canadian & British Insurance Companies Act, CAN. REV. STAT. c. 31, § 81 (1952), *as amended,* CAN. STAT. c. 13, § 16 (1961); Foreign Insurance Companies Act, CAN. REV. STAT. c. 125, § 37 (1952), *as amended,* CAN. STAT. c. 16, § 4 (1961); The Insurance Act, ONT. REV. STAT. c. 190, § 80 (1960), *as amended,* Ont. Stat. c. 63, § 3 (1962).

21 "Anyone, for example, who follows the activities of the Department of Agriculture comes to feel (though this is no doubt an exaggeration) that the Department is a glorified farmer's lobby. An examination of the milk licensing activities suggests the enormous power of the farm cooperatives . . . ." L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 23, 24 (1965). Although an executive department, not an independent regulatory authority, has been described, the analogy is not inapposite since there is but a small step between milk licensing and licensing or chartering a bank, trust, or insurance company.

22 Writing of the United States, Professor Kenneth Culp Davis stated: "The banking agencies of the federal government have long maintained systems of secret evidence, secret law and secret policy. The result has been a degree of unchecked and unstructured discretionary power that is far greater than it should be." Davis, *Administrative Procedure in the Regulation of Banking,* 31 LAW & CONTEMP. PROB. 713 (1967). *See also* K. DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY 120-22 (1969).

23 "Lack of definite standards creates a void into which attempts to influence are bound to rush; legal vacuums are quite like physical ones in that respect. Although pressure produces diffuse decisions, it is likewise true that diffuse decisions produce pressure; and pressure from one party to a case, or even a reasonable fear of it, arising from experience, will produce pressure from others." H. FRIENDLY, BENCHMARKS: SELECTED PAPERS BY AN EMINENT FEDERAL JUDGE 104 (1967).

report be implemented by provincial securities commissions, mutual funds would be required to include an in-depth statement of investment policy in their prospectuses. Perhaps variable policies, which are in direct competition with the funds and which are under the control of a superintendent of insurance, should be subject to similar disclosure requirements[24] and, thus, the same generalized regulation as the funds. The Committee report is the first all-government review of mutual funds. It proposes a comprehensive scheme of substantive regulation. Yet, even in terms of simply making recommendations, it promulgates a constricted view of coverage, as well as a failure to accept the reality of the financial conglomerate and the need for a regulatory agency empowered to deal with that conglomerate as a whole.

Today Canada enjoys no comprehensive regulatory scheme over mutual funds. There is no regulatory agency, federal or provincial, that views its function as one necessitating or permitting the imposition of pervasive rules of conduct for this growing and changing industry. Rather, there is fragmentation and jurisdiction divided between levels of government, between branches of the same government, and between governmental agencies and self-regulatory associations established by the industries concerned.[25]

The Canadian mutual funds industry, however, is subject to existing laws and self-regulation bearing directly on investment behavior. Specifically, there is the Income Tax Act, the prospectus requirements of a securities act, and the law of incorporation. All of these directly affect the funds industry. Their relevance, the vigor with which they are implemented, and the industry's view of their function in the context of law are the substance of this article. Where provincial legislation is

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24 In recent years, investment media essentially similar to those issued by mutual funds have begun to be issued by trust companies, banks and insurance companies. Trust companies operate pooled common stock trust funds against which certificates are issued. Banks have established mutual fund subsidiaries which are operated, at present, under the same legislation as mutual funds. Some insurance companies have begun issuing "variable annuity" contracts which are, in effect, mutual fund plans with some insurance features. Some of these instruments are issued under the legislation governing the parent institution, some under the Securities Acts . . . . In our view it is imperative that disclosure by these media be placed on a comparable basis. The primary reason is to ensure that the investor has information pertinent to his investment decision. A secondary reason is to ensure that all institutions offering such investments compete on an equal basis.

Paper 9: The Role of Formal Disclosure in Providing Information to Investors, in QUIRIN & WATERS, A STUDY OF THE CANADIAN MUTUAL FUNDS INDUSTRY 9-3 (1969).

25 MUTUAL FUNDS COMMITTEE REPORT 715.

considered, especially that relating to prospectus requirements, only the law of Ontario is set forth. It is true that the law of Quebec or British Columbia may operate on mutual funds desiring to sell shares in those provinces, and that funds may be subject not only to multiple prospectus requirements, but also to increased costs that accompany compliance with the law. Ontario, however, has set the lead for other provinces in securities regulation. The Ontario Securities Act of 1966 has become a model for many provinces; moreover, the 86 mutual funds qualified for sale in Ontario, which possess the bulk of industry assets, tend to follow in other provinces the Ontario practice concerning prospectuses; therefore, the Ontario legislation is fairly representative of general practice.[26]

THE INCOME TAX ACT

The literal structure of Canadian tax law should have a significant impact not only on fund investment behavior but also on the desirability of the fund as an investment medium. Through its administration, however, the federal taxing authority has softened the impact of law; nevertheless, there is nothing certain about the unarticulated exercise of discretion, and the law literally applied could have dramatic effect on the fund industry.

From a tax standpoint, the existing status of the funds is clear: funds are not taxed as businesses in terms of profits derived from the sale of securities[27] and fund shareholders are favored with tax-free treatment on profits derived from the sale of securities since capital gains are not taxed in Canada. In a rising market, funds can become attractive as an investment medium. The fund itself incurs no tax liability on the purchase or sale of shares for its portfolio. Furthermore, due partly to government restraint, the fund may be able to engage in frequent trades —in high turnover of given issues—without substantial fear of having the profit it obtains treated as ordinary income. Thus, the fund as an institution may be able to achieve what the individual cannot, namely, capital gains treatment while engaging in the trade of dealing in securities and buying and selling without the intent of investing.

The initial question is whether a mutual fund, whether organized as a corporation or as a trust, is in the business of trading in securities. If it is, the profits derived are likely to be treated as ordinary income, and

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[26] *Id.* at 576.

[27] Losses, of course, would not be deductible from ordinary income. Indeed, this aspect of the subject may account in part for the position of the taxing authority. *See* Gulf Securities Co. v. Minister Nat'l Revenue, 10 Can. Tax App. Bd. 338, 341 (1954).

it will be difficult for the fund, so characterized, to allocate any of its monies to an investment account. The Report of The Royal Commission on Taxation in 1966 stated: "[U]nder existing tax law, security gains earned as a result of trading activities are taxable, but if derived from investment activities they are not subject to tax. Some financial institutions find themselves in the peculiar position of being taxed on some of those gains and not on others." [28] Banks, trusts, and insurance companies may be able to separate functions; mutual funds have difficulty in doing so since their singular function is the achievement of a specific investment policy.

The Income Tax Act of 1952 comes into play by defining those subject to income tax. If mutual funds are considered a trade or an adventure or concern in the nature of a trade, they may have their profits subject to tax, and their losses deductible from ordinary income.[29] Precedent was set as early as 1904 in *California Copper Syndicate v. Harris*,[30] where the court treated returns from the sale of a portion of the company's property as income and distinguished between a mere change in the form of investments and the conduct of a trade or business.

By 1956, in *Minister Nat'l Revenue v. Taylor*,[31] the Exchequer Court had established the first Canadian judicial guidelines to aid in determining whether a particular transaction was one in the nature of trade. At issue was the purchase, in a short-supply market, of 1500 tons of lead

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[28] 4 ROYAL COMM'N ON TAXATION, TAXATION OF INCOME 383 (1967) [hereinafter cited as CARTER COMM'N REPORT]. The Carter Commission would subject all capital gains to tax.

[29] The inclusion of a broad definition of "business" in section 127(1)(e) of the *Income Tax Act* of 1948 (now section 139(1)(e) of the *Income Tax Act* of 1952) substantially enlarged the ambit of the kind of transactions the profits from which are subject to income tax. The definition no doubt was taken from The Income Tax Act of the United Kingdom, section 156(1) of which defines "trade" as including "every trade, manufacture, adventure or concern in the nature of trade." The Canadian definition is of even wider scope, in that "'business' includes a profession, calling, trade, manufacture of *undertaking of any kind whatsoever* and includes an adventure or concern in the nature of trade but does not include an office or employment." (emphasis added).

D. SHERBANIUK, THE CONCEPT OF INCOME—THE RECEIPTS SIDE, STUDIES OF THE ROYAL COMMISSION ON TAXATION No. 20, at 46-47 (1968).

[30] 5 Tax Cas. 159, 165-67 (Scot. Exch. 1904). *California Copper Syndicate* has been distinguished in a number of cases on the basis of intent. In *Tebrau Rubber Syndicate, Ltd. v. Farmer*, the company's prospectus was used to establish investment intent. 5 Tax Cas. 658, 665-66 (Scot. Exch. 1910). For the mutual fund industry there is an obvious lesson to be learned from such use. It is at this point that the role of a securities commission, such as the Ontario Securities Commission, can come into play through its control over a fund's prospectus by forcing full and true disclosure.

[31] [1956] Can. Tax Cas. 189, 210-12 (Exch. Ct.).

by the general manager of a metal products company. The lead was sold to the company at a substantial profit. The manager not only made a profit but advanced his position, gained prestige, and achieved an increase in salary and pension rights. Ruling that the profit was ordinary income and not a capital gain, the court said that neither the singleness of the transaction nor the nonexistence of an organization was solely determinative of whether the transaction was an adventure in the nature of trade.[32] Rather, it was the nature of the specific transaction which had to be examined, as well as the manner in which the transaction was conducted. The nature and quantity of the subject matter may also be determinative.[33]

The *Taylor* criteria have been imposed in a number of cases involving brokerage houses, and even in one case involving a trust designed to operate in much the same manner as a mutual fund. Brokerage houses buying for their own account[34] and a mutual fund buying fund shares from those seeking redemption and later reselling at a profit[35] have had their gains classified as income. The transactions in which they were engaged were held to constitute ordinary business and were neither for investment nor for the purpose of receiving dividends or interest.

The status of funds which serve as intermediaries in the purchase or sale of securities has never been ruled on as such. An argument can be made that funds or their equivalent are engaged in the trade of purchasing and selling securities, and that profits or losses derived from such transactions should be considered ordinary income or deductions from ordinary income. The only published statement affording a quasi-official counter-view comes from the Royal Commission on Taxation, such statement equating investment funds which pool public investment with conduits between the income source and the investor,[36] and, thus, not viewing the mutual fund as a separate taxable entity. Funds are entities, however, over which there is managerial control. Pursuant to this control, securities are bought and sold, and management's compensation is

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32 *Id.* at 1137.

33 D. SHERBANIUK, *supra* note 29, at 47-48.

34 McMahon & Burns Ltd. v. Minister Nat'l Revenue, [1956] Can. Tax Cas. 153, 157-58 (Exch. Ct.). An investment dealer, part of a underwriting group, took a portion of an issue for its own account as an investment. The court held: "Buying for Jack or buying for Jill seem pretty well alike [that is, buying for resale or buying for investment in terms of the underwriting] and it would require a subtler mind to single out any real objective distinction in this case . . . ." *Id.* at 1094. *See also,* Gairdner Securities Ltd. v. Minister Nat'l Revenue, [1954] Can. Tax Cas. 24, 27; Norman R. Whitall v. Minister Nat'l Revenue, [1967] Cas. Tax Cas. 377, 393.

35 Minister Nat'l Revenue v. Independence Founders Ltd., [1953] Can. Tax Cas. 310.

36 CARTER COMM'N REPORT 17.

in direct relation to the volume of portfolio turnover and, most importantly, to fund performance.[37]

However suspect the analogy, the fund industry for the moment is regarded as a conduit in the purchase and sale of securities. In an inflationary economy, this should add to the ability of mutual funds, and those institutions performing similar functions, to attract capital, since no additional tax is levied at the institutional level. It is necessary, however, to buy for investment in order for there to be capital gains treatment upon a subsequent sale or disposition, and it is certainly not clear what the tax treatment will be on a fund which embarks upon a policy of leveraging issues—taking heavy positions, sparking a rise in issue price, and then selling its position.

In *Gairdner Securties Ltd. v. Minister Nat'l Revenue*,[38] the Supreme Court of Canada held that gains derived from a taxpayer's in-out trading were to be treated as ordinary income. Of 22,260 shares purchased by Gairdner after 1946, 2,000 were resold the same day, 1,000 within one month, 2,500 within two months, and 3,500 within six months. Gairdner contended that these purchases and sales were merely changes in investment. The Court held that:

> Investments, in the sense urged, look primarily to the maintenance of an annual return in dividends or interest. Substitutions in the securities take place, but they are designed to further that primary purpose and are subsidiary to it. On the facts before us, there cannot, in my opinion, be any real doubt that there was no such dominant purpose here.[39]

Thus, it is reasonable to assume that the funds would be compelled to accede to more conservative investment behavior to insure ongoing capital gains treatment; therefore, there would be limits to the "go-go" or "in-out" fund. As a matter of law, funds would buy to hold, since to do otherwise would place funds in the position of trading and not investing, thus having their profits treated as income.

Although the general import of the law seems clear, administrative interpretation, at least as manifested by silence, puts that law in a different cast. Mutual funds have not been inhibited in their trading pat-

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[37] In *Anderson Logging Co. v. The King*, it was held: "The sole *raison d'etre* of a public company is to have a business and to carry it on. If the transaction in question belongs to a class of profit-making operations contemplated by the memorandum of association, *prima facie*, at all events, the profit derived from it is a profit derived from the business of the company." [1917-1927] Can. Tax Cas. 198, 207 (1924).

[38] [1954] Can. Tax Cas. 24, 27.

[39] *Id.* at 1016.

terns by the tax laws. The statistics seem to indicate that while "in-out" trading may be limited in the Canadian equity market, many Canadian funds regard the United States market as a locus for secondary liquidity, for investment that may be substantial and quickly liquidated.[40] The present high frequency of trading by mutual funds seems to be based upon administrative silence in Ottawa. To date there have been no publicly challenged fund transactions—no attempts to have profits from share trading declared income—by the taxing authorities.

The funds cannot be blamed for relying upon implied agency interpretation. After all, the obligation of fund directors is to act in the interests of their shareholders within the limits set by law. On the other hand, the difficulties facing the taxing authority cannot be ignored. The pool of fund investors is in constant flux. Redemptions may be made at any time as a matter of right. A fund may engage in a transaction which it believes deserves capital gains treatment and its portfolio will be valued accordingly. Redemption may take place. Should the taxing authority disagree with the treatment given, it is not easy to say who will be penalized and who will be benefited. Thus, until rules can be shaped, Canadian mutual funds enjoy administrative freedom from what could be constricting law.[41]

What has been said of mutual funds could be applied to other institutional investors in Canada. The reason for focusing on funds in relation to the tax laws is that it is they who are primarily concerned with the equity market and, as a matter of competition, have probed the profit of high volume trading through the venture or speculative fund.

From the all-government committee report on mutual funds came factual confirmation of the funds' ambivalent behavior in light of the tax laws. Addressing itself to the period 1962-1967, the report stated:

> Canadian mutual funds are constrained in their trading practices by the necessity of having gains made on the sale of securities taxed as ordinary income. Their objective is to show that the policy followed is to invest rather than trade. For this reason the investment managers attempt to restrict portfolio turnover; many follow a

40 *See Paper 14: Investment in U.S. and Foreign Securities,* in QUIRIN & WATERS, A STUDY OF THE CANADIAN MUTUAL FUNDS INDUSTRY 14-1 (1969); *Paper 15: Problems of Investing in Canadian Securities: Market Thinness and Disclosure Standards of Canadian Corporations,* in QUIRIN & WATERS, A STUDY OF THE CANADIAN MUTUAL FUNDS INDUSTRY 15-1-3 (1969).

41 Again, the impact of other law, such as the prospectus requirements of provinces like Ontario, must be considered. The primary statutory thrust is in terms of investment behavior related to capital gains treatment and the question of the fund as a trading enterprise. *But see* CARTER COMM'N REPORT 18.

> policy against the realization of a capital gain until the particular securities have been held for, say, a year. In spite of this restriction, the proportionate volume of trading has increased substantially in recent years.[42]

The increase in turnover has not come from Canadian funds trading in Canadian securities, but rather from Canadian funds trading in U.S. securities.[43] Indeed, the difference in turnover rate is so significant that the Committee felt that fund managers followed different investment policies in the two markets.[44]

Viewing the Canadian market, the Committee found a stabilizing influence in fund trading patterns on the basis of the data obtained. In part, this results from the thinness of the Canadian market; it is not difficult for institutions to absorb substantial portions of outstanding stock with relative ease.[45] Such positions, however, often can be obtained only when markets are falling and abandoned when the price is rising;[46] in this way, funds frequently trade against the market and thereby serve as a stabilizing force.

Considering the realities of investment behavior, the Committee made a number of suggestions designed to allow funds greater flexibility, the essence of which was to place funds in the same position as individuals to the extent consistent with institutional operations.[47] The Committee recommended the establishment of two kinds of funds, conventional and

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[42] MUTUAL FUND COMMITTEE REPORT 83.

[43] *Id.* at 84.

[44] *Id.* at 86.

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> The activities of the financial institutions are the most crucial aspect in any assessment of the possible future demands for Canadian stocks. Over the next few years the total equity holdings of the major financial institutions could easily grow to triple their 1966 holdings. The holdings of foreign stocks by these institutions are already substantial, and if they find it necessary to invest half of their total equity portfolios in foreign equities (because of the inadequacy of domestic supply) by the early 1970's they could be holding $5 billion in foreign equities.

G. CONWAY, THE SUPPLY OF, AND DEMAND FOR, CANADIAN EQUITIES 43 (1968).

[46] MUTUAL FUND COMMITTEE REPORT 89.

[47] Funds should differ from individuals only in the sense of being able to meet demands for redemption. This qualification would place some constraints on liquidity and on the type of investments funds might make. Thus, it would be improper for a fund to own a building, even though it might be entirely appropriate for it to own shares in a real estate development corporation. So, too, a fund should insure a cash flow sufficient to meet redemption demands at share net asset value. To do this, however, a fund should not be permitted to borrow the entire worth of its net assets. *See id.*

nonconventional.[48] For the investor seeking a nonconventional fund, one with specialized investment objectives not presently followed by members of the industry, the Committee sought limited accommodation. The nonconventional fund would be permitted, *inter alia,* to effect short sales and to borrow money for leverage and for the purpose of effecting redemptions, provided that its total liabilities for all three at no time should exceed 75 percent of its borrowing base.[49] The difficulty under present Canadian tax law is patent. A fund having as investment objectives short sales or leverage could not, under any circumstances, be characterized as an investor; the fund would be trading, and its gains or losses would be treated as ordinary income. It must be assumed that the Committee understood the import of its recommendations. Properly labelled as such, the speculative fund was not to be discouraged, for it might further stimulate competition in the fund industry;[50] at the same time, the Committee did not seek to change the distinction between capital gains and ordinary income. It sought only to allow greater institutional investment flexibility.

Whatever the Committee intended, there is every likelihood that the capital gains-ordinary income distinction will be altered materially. In 1969 the Government published a White Paper, *Proposals for Tax Reform,*[51] which proposed that all gains and losses, except those incurred in sales of stock of Canadian widely held corporations, be treated as ordinary income. Thus, for the mutual fund dealing in U.S. securities, the proposed Canadian tax laws would offer no particular incentive in terms of seeking capital gains as contrasted to ordinary income;[52] however, for those trading in stock of Canadian widely held corporations, which would include any corporation listed on a Canadian stock exchange,[53] the historic distinction would still have a considerable meaning.

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[48] *See id.* A nonconventional fund could be defined in the negative. It would be what a conventional fund is not in terms of investment objectives.

[49] *Id.* at 434, 435.

[50] One of the principal thrusts of this report is toward a more highly competitive structure within the mutual fund industry, so that it will better serve the investing public. There is a role, and an important role, to be played by mutual funds with specialized investment objectives and practices designed to cater to investors with particular needs, even if these mutual funds make use of investment practices inconsistent with the restrictions presently in effect.

Id. at 421-22.

[51] E. BENSON, PROPOSALS FOR TAX REFORM (1969).

[52] *Id.* at 40-41.

[53] *Id.* at 52. To accomplish this objective, the Committee recommends that the prospectus be in narrative form. It should be capable of being read by investors generally and not only by security analysts and other trained persons.

For the first time a tax would be imposed on capital gains, but it would be favored, only half of the gain being considered taxable income.[54]

The Government's proposals for tax reform must be viewed most seriously. If implemented they will have direct effect on mutual fund investment behavior. In the context of capital gains treatment, one must also read the "special rule" for mutual funds suggested by the White Paper:[55] A fund would be treated as a conduit for limited purposes only. The White Paper stated:

> This type of corporation [a fund] must be able to put its shareholders in the same position as if they themselves had realized their proportion of the capital gains of the mutual fund arising on the sale of shares in public Canadian corporations. In the absence of a special provision mutual fund shareholders would pay tax on the full amount of such gains when they were distributed to them, whereas tax should be applied only to half of the gain. Consequently [a fund] would be enabled to make special distributions to its shareholders which would be treated as though they were a capital gain on the sale of a Canadian corporation.[56]

The tax law presently imposes a quiet restraint on institutional investors in general, and funds in particular, to invest rather than trade and to hold rather than sell. The tax law as it would operate if the White Paper proposals are accepted would at one and the same time emphasize and narrow the present course of conduct. Today it matters little whether a fund enters transactions in the United States or in Canada, or whether it buys widely or closely held shares. The future may find significant tax incentives dangled before institutions to buy publicly listed Canadian enterprises if only half the income coming from listed Canadian capital transactions would be taxable. The conventional fund would continue to have an advantage over a nonconventional fund engaged in short sales or leverage.

The "buy Canadian" incentive could do much to institutionalize an already thin Canadian auction market. For Canada, this means that the relatively few financial institutions controlling most of their respective industries, including the two mutual fund complexes that hold 50 percent of all fund assets, will be encouraged to assume illiquid, locked-in, control positions in publicly listed Canadian issues. Indeed, quite aside from the White Paper, the larger funds have already shown a desire to

[54] *Id.* It follows that only half of the loss from such transactions would be treated as an ordinary loss.

[55] *Id.* at 56.

[56] *Id.*

acquire 10 percent or more of outstanding Canadian stocks. Holding a substantial block of a portfolio and being unable to liquidate its position with ease, fund management may decide to reassess its function.

SECURITIES LEGISLATION: THE PROSPECTUS IN ONTARIO

Actual power to control fund investment behavior rests with the Ontario Securities Commission, though the legal base for the exercise of that power may be questioned. Presumably the Commission not only might command detailed disclosure of fund investment policy, but also might require that funds buy to hold and abstain from "in-out" trading. Control over disclosure and investment behavior would be made possible by the Commission's exclusive jurisdiction in approving a fund prospectus.

Before dealing with actual Commission practice and fund compliance with Commission order, the conceptual background of the prospectus in Ontario and an explanation of the distinction between realistic power and legal right must be given. The Kimber Committee, whose 1965 report to the Attorney General led to the 1966 Securities Act of Ontario, cited with approval the approach taken by the United States Securities and Exchange Commission. Since the purpose of the prospectus is to inform investors, the Committee felt that the information presented should be clear, concise, and understandable.[57]

In requiring that the prospectus provide "full, true and plain disclosure of all material facts relating to the issue to be sold," [58] the Securities Act of 1966 carried forward the implications of the Kimber Committee Report. Additionally, the prospectus must comply not only with the Act, but also with regulations issued under it.[59] Significantly, the Director of the Commission was given discretion in the issuance of receipts for any filed prospectus.[60] Thus, the statute suggests that even though there is full disclosure, the Director may, in his discretion, withhold permission to conduct a public sale of securities.

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[57] THE ATTORNEY GENERAL'S COMM. ON SECURITIES LEGISLATION IN ONTARIO, REPORT 40 (Mar. 11, 1965).

[58] Securities Act, 1966, ONT. STAT. c. 142, § 41(1) (1966). Only the prospectus requirements will be discussed in this article. There are, of course, other regular reporting requirements which were generally applicable to funds in 1966, and in 1968 were tailored by the legislature to fit fund operations. *See* An Act to Amend The Securities Act, 1966, ONT. STAT. c. 123, §§ 33-36 (1968). These reporting requirements, however, do not constitute an attempt by government to regulate investment behavior.

[59] Securities Act, 1966, ONT. STAT. c. 142 § 41(2) (1966).

[60] *Id.* § 61(1). In part, the purpose of this section seems to be to deny discretion to the Director in issuing a receipt where the prospectus fails to meet certain listed requirements.

If the general prospectus provisions are applied to the mutual fund industry, there is the potential for immediate impact on investment behavior. Funds are intimately tied to the Securities Act of 1966; they are continually redeeming existing shares, selling new shares, and engaging in an ongoing public offering.[61] Under the Securities Act, the potential control which the Commission could exercise over the fund industry is enormous. In terms of disclosure alone, the Commission could require an in depth statement of fund investment policy. In its regulations, the Commission has sought to achieve this end.[62] A special form was devised for funds,[63] with five of 26 items listed in the form bearing directly on investment policy.[64] Others touch upon the problem somewhat less directly;[65] under the heading "Fundamental Policies of the Issuer," a fund must declare its position as to certain enumerated matters. These include: (1) issuance of securities other than those offered; (2) concentration of investments in a particular class or kind of industry; (3) underwriting of securities of other issuers; (4) purchase and sale of real estate; (5) purchase and sale of commodities or commodity future contracts; and (6) the making of loans, secured or unsecured.

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[61] It is, of course, possible for a fund to reject Commission regulation by simply discontinuing the sale of fund shares. This did occur in 1968-1969. In essence, an open-ended fund became closed-ended. *See* MUTUAL FUND COMMITTEE REPORT, *supra* note 1, at 19.

[62] Securities Act, 1966, ONT. STAT. c. 142 § 61(1)(a)-(e) sets the legislative context for the regulations. Under section 61(1)(a)(i-iii) the Director may direct the Registrar to issue a receipt unless "the prospectus or any document required to be filed therewith (i) fails to comply in any substantial respect with any of the requirements of this Part or the regulations, (ii) contains any statement, promise, estimate or forecast that is misleading, false or deceptive, (iii) conceals or omits to state any material facts necessary in order to make any statement contained therein not misleading in the light of the circumstances in which it is made . . . ."

[63] Under the Securities Act Regulations, 1967, § 12, 2 CCH CAN. SEC. L. REP. ¶ 51-741, the prospectus of a fund must comport with the requirements of Form 12, 2 CCH CAN. SEC. L. REP. ¶ 51-983. In this regard, the power of the Director to enlarge upon the definition of mutual funds cannot be ignored. The regulations specifically state: "'mutual fund company' means a company designated by the Director as a mutual fund company." § 8(h), 2 CCH CAN. SEC. L. REP. ¶ 51-737. This power, however, could not override legislation which exempts certain industries from the Act itself.

[64] These are item 6 (Fundamental Policies of the Issuer); item 7 (Policies with Respect to Security Investments); item 8 (Diversification of Assets); item 9 (Tax Status of Issuer); item 10 (Tax Status of Security Holder). 2 CCH CAN. SEC. L. REP. ¶ 51-983, at 9931-10-11.

[65] Item 15 dealing with the funds dividend record; item 16, identifying the directors and officers; item 19, stating functions of issuer and distribution of securities; and, finally, item 1, relating to redemption rights. *Id.*, ¶ 51-983, at 9931-9, 9931-12-13.

As a final subitem, the Commission asks for a statement of "any other policy which the issuer deems fundamental." [66]

The Commission also requires a description of six matters which might not be considered by a fund to be fundamental. These matters are:

> (a) the type of securities (for example, bonds, preferred shares, common shares) in which it may invest, indicating the proportion of the assets which may be invested in each type of security;
> (b) the percentage of assets which it may invest in the securities of any one company;
> (c) the percentage of securities of any one company which it may acquire;
> (d) investment in securities of companies for the purpose of exercising control or management;
> (e) investment in securities of investment companies or other mutual fund companies; and
> (f) any other investment policy not specified . . . which is set out in the issuer's letters patent, other constating documents, bylaws, articles or regulations.[67]

Should a fund hold five percent of any company's issue, regardless of class, the Commission demands tabulation in the prospectus. The fund must give the name of the company, its principal business, the percentage of securities directly or indirectly held by the fund, and the percentage of fund assets at book value invested in the particular company.[68] Finally, a fund must state the general basis upon which the income and capital receipts of the issuer are taxed[69] and the income tax consequences to fund shareholders, with specific reference to distributions whether they be in the form of dividends or otherwise.

Through this burdensome array of items to be disclosed, the Commission derives substantial control over fund investment behavior. The statements must be both truthful and in complete harmony, and if such harmony does not exist the Commission can ask for clarification.[70] Since there have been no rulings by the Commission, there is no indication to

[66] *Id.* item 6(a)-(h), ¶ 51-983, at 9931-10.

[67] *Id.* item 7(a)-(b).

[68] *Id.* item 8, ¶ 51-983, at 9931-11.

[69] *Id.* items 9-10.

[70] *See* UNITED ACCUMULATIVE FUND LTD., PROSPECTUS, Dec. 15, 1967, at 4. "No security will be purchased unless in the opinion of management a reasonably good market exists for its resale . . . ."

the public of agency concern over capacity to achieve fund investment policy. This is not to say, however, that the agency is unaware of the problem in other areas. "The Commission has . . . refused to accept a prospectus for filing where the indicated resources were insufficient to accomplish the objects indicated in the prospectus."[71] Moreover, through its power over the prospectus, the Commission has claimed the right to regulate fund management fees and other expenses,[72] even when such fees and expenses have been fully disclosed. The Commission has taken the view that the Securities Act meaning is clear: the agency may accept or reject a prospectus. The statutory terms are open-ended. Thus, so long as the agency imposes conditions on fund operations and treats them equally as a class, there is nothing to stop substantive regulation through control over the prospectus.

The Commission might have weighed the experience of the Board of Trade in England before embarking on substantive regulation. Acting on a statutory grant similar to that given the Ontario Securities Commission, the Board of Trade refused to grant an order authorizing a unit trust on the ground that its initial service charge was excessive.[73] The statute itself seemed to call only for disclosure of fees;[74] however, another proviso added these key words: "that the scheme [prospectus] is such as to secure that any trust created in pursuance of the scheme is expressed in a deed providing, to the satisfaction of the Board, for the matters specified in the Schedule to this Act."[75] On appeal, the Chancery Division allowed the Board itself the use of discretion, thus acknowledging its power to regulate "on the true construction of the Act."[76] The words of the statute were clear; it was not a matter for the court to question. The court did not stop there, however; it found a still broader ground for the use of Board discretion. Justice Danckwerts wrote:

> It seems to me that there is much to be said for the argument

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[71] *See* J. WILLIAMSON, SUPPLEMENT TO SECURITIES REGULATION IN CANADA 60 (1966).

[72] *Policy Statement of Ontario Securities Commission*, Feb. 1968, 2 CCH CAN. SEC. L. REP. ¶ 54-914; *Policy Statement of the Commission of the Ratio of Management Fees and Other Expenses to Net Assets*, Jan. 1969, 2 CCH CAN. SEC. L. REP. ¶ 54-930.

[73] Allied Investors Trusts, Ltd. v. Board of Trade, [1956] 1 All E.R. 162 (ch. 1955).

[74] The relevant statutes as given by the court were the Prevention of Fraud (Investments) Act, 1939, 2 & 3 Geo. 6, c. 16, § 16(1)(c) schedule, *as amended* Companies Act, 1947, 10 & 11 Geo. 6, c. 47, § 117(1). The schedule in question called for information "[f]or determining the manner in which the manager's prices for units on a sale and purchase respectively and the yield therefrom are to be respectively calculated and for entitling the holder of any units to require the manager to purchase them at a price calculated accordingly." [1956] 1 All E.R. at 166.

[75] [1956] 1 All E.R. at 167.

[76] *Id.*

> that the Board of Trade have this general discretion [to refuse to authorize unit trust schemes] and under the terms of the Act are not bound to make an order merely because the matters stated in the schedule are duly contained in some form or other in the deed submitted to them. . . . I should be inclined to come to the conclusion that the Board of Trade had such discretion . . . ." [77]

The court did not consider the intent of the legislature in construing the statute. The language of the Act seemed plain. So, too, the language of the Securities Act of 1966 seems clear. Yet, none can doubt the intent of the legislature as it relates to the prospectus, for, in this regard, the Kimber Committee Report[78] was without ambiguity. A prospectus is designed only for the purpose of full disclosure of relevant data. Nevertheless, the Ontario Securities Commission continues to use its power over the prospectus as a means of substantive regulation. There has been no formal appeal by the funds either to the agency or to the courts.

The mutual fund industry is placed in the difficult position of having legal rights which cannot be pursued. Any appeal from the Commission takes a long time to process and the funds are bound by law while the appeal is pending and cannot sell shares in the absence of a prospectus. Thus, even after winning on such an appeal, the fund still loses. A court will pass only upon the issue and prospectus presented to it; the fund would be compelled, even after a court judgment, to draft a new prospectus reflecting the changes in the facts taking place while the appeal was pending. With the new prospectus, the entire process could begin again.

Both the Commission and the funds exist in a shadow world because of the discretion which the Commission has assumed. The Commission exercises the power to regulate the funds, but whether that power could withstand judicial attack is still unclear. The funds are handling an ever shifting base of other people's money and cannot afford to risk Commission displeasure. Good business judgment may dictate that the funds respond to agency questions only to the extent necessary, that they adopt the agency's terms of reference even if they bear slight resemblance to the existing state of business life, and that they make no effort to provide the public with an in-depth detailed statement of investment policy beyond that which the law requires.

Since there are few fixed guidelines either to the exercise of Commission discretion or to fund investment behavior, any variance in a prospec-

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[77] *Id.* at 169.

[78] THE ATTORNEY GENERAL'S COMM. ON SECURITIES LEGISLATION IN ONTARIO, REPORT, (Mar. 11, 1965); *see* note 57 *supra* and accompanying text.

tus from a bland norm may invite rejection by the Commission. Instead of being a vehicle for full disclosure, the prospectus may become an invitation to Commission regulation without recourse. The Commission may be both aware of its potential power and reluctant to require greater disclosure since such a requirement would compel the Commission to regulate in areas which are presently beyond its concern.

The typical Canadian fund prospectus contains no firm, positive statement of investment policy and often no statement of any kind relating to capital gains treatment either for the fund or its shareholders.[79] Where a fund ventures precision, it invites criticism. For example, a fund which states in its prospectus that "[n]o security will be purchased unless in the opinion of management a reasonably good market exists for its resale . . ." [80] and which has 14.35 percent of its assets tied up in several stocks of which it holds five percent or more[81] is inviting inquiry by the

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[79] THE UNITED ACCUMULATIVE FUND LTD., PROSPECTUS, (Dec. 15, 1967), provides a typical example of a statement relating to tax status. Indeed, United's statement is somewhat more expansive than most funds. *See, e.g.*, UNITED AMERICAN FUND LTD., PROSPECTUS, 5 (Aug. 18, 1967). United Accumulative's answer to Form 12 is:

> (f) *Tax Status of Shareholders*
>
> Individual shareholders are subject to income tax on dividends paid by the Fund and either received by them in cash or reinvested in additional shares of the Fund on their behalf. Individual shareholders resident in Canada are entitled to a tax credit equal to 20% of the net dividend so received. Shareholders who are taxable Canadian corporations will not be subject to corporation taxes on any dividends paid by the Fund.
>
> (g) *Tax Status of the Fund*
>
> The Fund operates in such a way that it qualifies as an investment company under the provisions of the Income Tax Act. The Fund pays federal and provincial income taxes at rates totalling 23% of net income from dividends on foreign securities and interest. If it did not qualify as an investment company the Fund would pay tax as a normal Canadian company, calculated at rates totalling 23% of taxable income up to $35,000 and 52% of the balance of taxable income. In either case dividends received from most Canadian companies are exempt from income tax. The wholly-owned subsidiaries each of which holds securities of companies outside of Canada representing not more than 10% of the consolidated assets of the Fund, do not qualify as investment companies. Each such subsidiary is established as a Canadian company to provide a means of paying tax at the normal corporate rates provided by the Income Tax Act on earnings from their investments, without changing the 23% tax rate currently applicable to the earnings of the Fund which qualifies as an investment company.

There have been a few funds, however, which touch the question of capital gains, albeit briefly. *See, e.g.*, FUND SPEC, PROSPECTUS 7 (Apr. 25, 1967) ("The Fund expects to conduct its investment activities in such a manner so that capital gains realized on the sale of securities will not be subject to either Canadian taxes or United States capital gains tax under present legislation.")

[80] *See* notes 70-71 *supra* and accompanying text.

[81] *Id.*

Commission as to how the fund could liquidate these securities with relative ease and where the resale market exists. In asking these questions, the agency would be concerning itself with the narrow matter of share liquidity; the fund stated that its shares had ready liquidity, and this was a dubious statement. The fund would reply that it invested in issues which hopefully would rise in value, with the result that they could be resold at a later point. Generally, there is no need to sell such issues unless they become a bad investment; at that point, any holding regardless of size might lack liquidity.[82] Furthermore, there is usually no need to sell holdings to pay the redeeming shareholders, since the funds have been able to meet such demands out of new share sales and most funds reserve the right to pay redeeming shareholders in their proportional interest of the underlying shares.[83]

The combination of ambiguous law, ambiguous agency policy, and fund restraint results in an innocuous prospectus statement of investment policy. In their study sponsored by the Canadian Mutual Funds Association, Quirin and Waters argued for more detailed public disclosure of investment policy. The beneficiaries would be the public—the consumers of fund shares—and the funds themselves. Specifically, they placed significant emphasis on investment objectives,[84] managerial skills,[85] and financial disclosure of past performance as a means for testing the "pedigree" of the fund,[86] namely the capability of its management.

Quirin and Waters reasoned that the investment objectives of the fund explain many of the apparent differences in realized returns and risk and can be useful as an initial screening device. If the investment policies of the fund in fact are compatible with its stated objectives, the investor will generally be able to select a fund in a particular risk-return range.[87]

To aid in shaping a more precise investment policy, Professors Quirin

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[82] The questions relating to liquidity will be dealt with in the second argument of our treatment of mutual funds. At this point it is only necessary to state that generally there always is a market for a listed issue. The more significant problem, however, is the price at which one must sell in order to attract a buyer.

[83] UNITED ACCUMULATIVE LTD. PROSPECTUS, *supra*, note 70, at 15.

> Payment by the Fund for such shares so surrendered shall be made by cheque payable to the registered owner thereof except that, if, in the opinion of the board of directors, which shall be conclusive, conditions exist which make payment wholly in cash unwise or undesirable, the Company may make payment wholly or partly in securities or other property the value of which shall be determined as of the time the value of the shares is determined.

[84] *Paper 9*, *supra* note 24, at 9-4.

[85] *Id.* at 9-4, -5.

[86] *Id.* at 9-4.

[87] *Id.*

and Waters have followed the same approach as the Ontario Securities Commission in the particularization of subject matter. Two of the points made in this study, which was sponsored by the fund industry, are objectives which by inference the industry itself could achieve in principle. The first point is that investors have a right to know the fund's trading philosophy, specifically whether the fund intends to accomplish its goals through buying and holding or through active trading.[88] The second point is that the investor should be furnished with a statement identifying and describing the qualifications of those who are involved in investment decisions and any material changes that occur.[89] Insofar as this latter point is concerned, there seems no reason why funds could not institutionalize and state the process of investment decision making. The majority of funds have externalized investment management rendered under contract to them. As a condition to the contract, the investment advisor could be required to describe its own line of organization with respect to investment decisions; the fund could do the same.[90]

Desirable as they may be, the Quirin-Waters' proposals may not be accepted by the Ontario Securities Commission until that agency first defines its own role in the regulation of mutual funds. Until rules are established, the funds cannot be expected to subject themselves to investment inhibition through greater disclosure, and the Commission, to date, has given no indication of demanding anything more than the bland statements already included in a fund prospectus. Thus, the law of disclosure has not affected funds in their investment behavior in the equity market.[91] The law has made more difficult, however, any under-

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[88] *Id.*

[89] *Id.* at 9-5.

[90] *See generally* D. BAUM & N. STILES, THE SILENT PARTNERS: INSTITUTIONAL INVESTORS & CORPORATE CONTROL (1965).

> A single trust department, charged with administering a large number of accounts and frequently vested with wide discretionary powers, may find it difficult to remain entirely faithful to all of them. Within the framework of national [United States] banking regulations, efforts are made to achieve this end. Responsibility for the proper exercise of fiduciary duties is placed squarely and exclusively with a bank's board of directors. Regular audits are required. Moreover the quality and nature of investments made are the proper subject of examination by the Comptroller.

Id. at 114.

[91] MUTUAL FUND COMMITTEE REPORT, *supra* note 1, at 408-09.

> [R]egulatory attention has tended to focus on the statement of investment practices rather than on the statement of investment objectives. . . . The difficulty is that no attempt has been made to link investment practices with investment objectives. Similar restrictions on investment practices are imposed by administrators on all mutual funds. Regardless of their investment objectives, portfolio managers are anxious to be subject to as

standing of fund investment policy. The law has not been used to bring forth those facts which are both necessary and relevant to investment analysis.

Strenuous efforts were made by the all-government committee on mutual funds to make disclosure a real function of public protection. A subcommittee named by the group, consisting of a former securities administrator, a mutual funds officer, and two lawyers, unanimously recommended the preparation and dissemination of a readable summary prospectus at an early stage in the fund sales process. The summary would include those portions of the full prospectus which are of greatest importance to purchasers. Its format and content would be discussed between the securities administrator and the mutual fund organization[92] and could differ considerably between different funds. Periodic reports would be coupled with the summary and the prospectus itself. The securities administrator would be in a position to compel disclosure that not only would be useful to the public exercising their judgment as consumers, but also to the agency staff.

The fact remains that in Ontario prospectus conditions for mutual funds have not changed materially. Neither new legislation nor new regulations have been introduced; it must be emphasized that they are not likely to be proposed until the Ontario Securities Commission, through its Director and staff, believe change is warranted. There is no

> few limitations as possible on investment practices. As a result, virtually all mutual funds, regardless of their investment objectives, have statements of investment practices which are as liberal as the administrators will permit. This is the reason why the latter statements do not differ significantly among most mutual funds, and it also accounts for the paradox noted above: the differences among the vague statements of investment objectives are more meaningful than those among the precise statements of investment practices. It is also important that the former indicate what the mutual fund will do; the latter only indicate certain things that it will not do.

92 MUTUAL FUND COMMITTEE REPORT, *supra* note 1, at 535. To encourage a concise readable summary, the Committee Report further recommended that for inaccurate or false statements the statutory civil penalties applicable to the full prospectus should not attach. The Report provided an illustration of a summary by a hypothetical nonconventional fund:

> It is important for you to realize that the Fund takes risks in the pursuit of maximum capital gains on a long-term basis; among the risks it assumes are those involved in investments in small companies without established earnings records. The fund is known as a nonconventional fund because it is permitted to, and often does, borrow money to invest. All of these practices may increase the degree of risk; while the acceptance of risk may improve gains made by the Fund, it may also result in losses. *You should not invest in this mutual fund with money you cannot afford to lose.*

Id. at 536.

other governmental body, and no Parliamentary professional staff, sufficiently skilled to evaluate the fund industry.[93]

THE LAWS OF INCORPORATION: FEDERAL AND PROVINCIAL

Law sets the structure within which mutual funds must operate; however, that structure has had only a minimal effect on investment behavior. The form that a fund takes, whether trust or corporation, relates to investment behavior only in the areas of taxation and share or unit redemption. There are certain advantages to the trust. When a mutual fund is organized as a trust, income is taxed to the beneficiaries whether or not they actually receive any distributions. The 20 percent dividend tax credit is available to them on their share of the net dividends received by the fund from taxable Canadian corporations, and depletion allowances are passed through in much the same way. As a result, for tax purposes the trust is simply a conduit.

An incorporated mutual fund qualifying as an "investment company" may elect to be taxed either as an ordinary corporation or as an "investment company." An "investment company" pays a tax of 21 percent on taxable income which does not include capital gains and dividends from taxable Canadian corporations. The shareholder is entitled to a 20 percent tax credit on dividends he receives, so that the overall treatment is rather close to the treatment of an unincorporated mutual fund and its members. The Canadian Mutual Funds Association has argued that the tax position of incorporated mutual funds is inequitable, and that they should be treated as trusts. The Association has pointed out that the tax paid by incorporated funds is borne by all shareholders, regardless of their ability to use the dividend tax credit; a shareholder who cannot make use of the tax credit is better off, insofar as taxes are concerned, in an unincorporated mutual fund than in an incorporated one.[94]

In the past, funds have been able to redeem shares out of cash flow coming from the sale of new shares in the fund;[95] there has been no

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[93] The Report of the Mutual Funds Committee noted administrative opposition to some key proposals, including the establishment of nonconventional funds. To this the report seems to call not only for legislation, but perhaps equally important, curtailment of agency discretion. "A scheme such as we . . . recommend could not be applied by securities administrators exercising their discretionary power on a case-by-case basis; this is only one example of the difficulties in the existing method of control." *Id.* at 21.

[94] J. WILLIAMSON, *supra* note 71, at 409.

[95] Professors Quirin and Waters in their general discussion of liquidity are pointed in discussing problems flowing from redemption demand: "Neither sales nor redemptions of a fund's own shares can be forecast with precision . . . . Actual cash requirements for a given future day are never precisely known, and a fund must keep precautionary

need to liquidate underlying investments to meet demand.[96] A fund must be able to plan for the future and cannot operate, either in theory or in fact, on the assumption that major demands for redemptions can always be met immediately with cash outlays. Protective measures against a major onslaught of demand, however, do not arise solely out of vague fear coupled with conservative behavior.[97]

If other institutions acquired substantial holdings in a fund, the demand by one or more of them could easily exhaust cash reserves and force partial liquidation of underlying portfolio investment.[98] It is also true that where a fund is highly leveraged—fund assets are divided among relatively few issues—liquidation of any one issue in a downward market could reduce the demand for new shares, at the same time increasing the rate of redemption.[99]

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balances against the possibility that cash needs may turn out to be greater than expected." *Paper 13: Liquidity and Fund Operations*, in QUIRIN & WATERS, A STUDY OF THE CANADIAN MUTUAL FUNDS INDUSTRY 13-4 (1969).

[96] Our concern, it must be emphasized, is the impact of institutional investors on the Canadian equity market. The income which has been mentioned relates to dividends and interest. It does not cover capital gains which are not taxed as income. It should be noted, however, that even in terms of dividends and interest the Carter Commission would eliminate the distinction between the trust and corporate form. "Where a trust has issued transferable or redeemable units, each of which carries a specific undivided interest in the trust property and the trust income, the trust should be taxed in the same manner as a corporation." CARTER COMM'N REPORT, *supra* note 28, at 194.

[97] This results in the funds assessing the costs of having cash or securities that are readily marketable. *Id.*

[98] In 1966, the Securities and Exchange Commission referred to the Ontario incorporated Fund of Funds Ltd. which had assets of $420 million and had substantial holdings in U.S. mutual funds ranging from .6 percent to 100 percent of the funds' outstanding issue. The SEC stated: "[F]und holding companies . . . pose a real potential for the exercise of undue influence or control over the activities of portfolio funds. *The basis of this threat is the possibility of large-scale redemptions inherent in the ownership of large blocks of mutual fund shares by a fund holding company*." H.R. REP. No. 2337, 89th Cong., 2d Sess. 315 (1966) (hereinafter cited as SEC STUDY); *see* MUTUAL FUND COMMITTEE REPORT, *supra* note 1, at 444-45: "A substantial holding by one mutual fund in another mutual fund exposes the latter to the possibility of a redemption which might force a liquidation of portfolio securities, and would reduce total net assets and management fees. The power to effect such a redemption might be used by the management company of the fund or funds to exert influence over the policies of the underlying mutual funds." *Id.* As a result the Committee did not recommend against the abolition of the fund on funds but rather that it "should not be permitted to acquire shares or units of another mutual fund if, after such acquisition, the fund on funds, alone or together with other funds on funds under common management, would hold in excess of three percent of the outstanding shares or units of that mutual fund. This percentage limit corresponds to that contained in section 12(d)(1) of the [U.S.] Investment Company Act of 1940, and we think it appropriate for adoption in Canada." *Id.*

[99] Consider the fund that is highly leveraged and invests substantial sums in "letter stock" which often is unseasoned and, in any event, is in a primary distribution.

In Canada, funds have been permitted to exercise individual discretion[100] in establishing rules for redemption. The Ontario Securities Commission asks only for disclosure of redemption policy and a detailed statement covering valuation.[101] Those funds created as trusts may write into the chartering trust instrument whatever suits their purpose. The Trustee Act of Ontario which would otherwise govern investments under a trust[102] is inoperative.[103]

Of the 117 Canadian mutual funds in existence at the end of 1968, 62 were organized as companies and held the greater share of industry assets.[104] Here the law reaches the matter of fund redemption indirectly by dictating when a corporation may redeem its own shares. This approach is designed primarily to protect creditors of the corporation and, generally, to discourage the corporation from trading in its own shares.[105]

Professors Quirin and Waters note that such a purchase "does have certain implications for the marketability of the fund's portfolio and . . . believe that, where securities subject to restricted marketability are part of a portfolio, full disclosure of this feature should be made." *Paper 12: Trade Association and Related Restrictions on Fund Investment Policy*, in QUIRIN & WATERS, A STUDY OF THE CANADIAN MUTUAL FUNDS INDUSTRY 12-8 (1969).

100 In the absence of national securities regulation, an event not likely for many years, the Committee Report recommends that this discretion be left to the fund management when (a) the disposal by the mutual fund of securities owned by it is not reasonably practicable, or (b) a valuation of the assets of the fund is not reasonably practicable. MUTUAL FUND COMMITTEE REPORT 504.

101 *See Ontario Securities Act Regulations*, Form 12, Item 1, 2 CCH CAN. SEC. L. REP. ¶ 51-983.

102 *Id.* §§ 26-32. Section 26 sets the tone for itemization: "A trustee may invest any trust money in his hands in the classes of securities mentioned in this section, *but only if the investment is in other respects reasonable and proper . . . .*" *Id.* § 26.

103 *Id.* § 67. *See also* Trust Companies Act of Canada, CAN. REV. STAT. c. 272, §§ 64(2), 66(3), 66(5) (1952). Section 64(2) states: "The company may manage, sell, or dispose of investments as the terms of the trust pursuant to which they were made require or, in the absence of such requirement, as the directors, subject to the provisions of this Act, may see fit." *Id.* § 64(2). In many respects the trust deed provides less opportunity for unit holder information and control than that afforded to the shareholder of an incorporated fund.

> Because the trust agreement and the declaration of trust are subject to minimal legal restrictions governing their content, the mutual fund organizers have very great flexibility available in the decision as to what the relevant provisions should be. Few of these agreements and declarations give any voting rights to unit holders . . . . Its more important provisions are outlined in the prospectus, but that may not be available either. Finally, the fact that many of these documents are subject to amendment without prior consent of the unit holder may decrease the value of disclosure even where full disclosure is made.

MUTUAL FUND COMMITTEE REPORT 25-26.

104 MUTUAL FUND COMMITTEE REPORT 22.

105 J. WILLIAMSON, *supra* note 71, at 407-08.

Until recently, except for purposes of disclosure,[106] Ontario dealt with a fund as with any other corporation; under its Corporation Act only preferred or special shares could be redeemed. Thus, a fund created as a corporation in Ontario must provide for two classes of shares, common and special, and both must be set out in its letters patent.[107] The Act requires that there be a separate fund and, to satisfy redemption demands, that the price paid reflect the actual value of the shares. In the same letters or supplementary letters patent, the corporation must formalize its procedure for valuation of special, or fund, shares.

Nothing in the Act prohibits a fund from attaching redemption conditions applicable to all special shareholders or from suspending or modifying the right of redemption upon the happening of stated events; rather the Act allows the individual formulation of redemption rules. The thrust of the Act is not wholly relevant to the fund industry, though the same statute firmly binds those members seeking provincial incorporation.[108] Perhaps for that reason or perhaps as a response to federal legislation, changes were made in 1970 that will allow mutual fund shares to be redeemed in the manner and according to the conditions set out in the fund's articles of incorporation.[109]

In some respects, the Canada Corporations Act seems more in tune with fund reality. It specifically permits a classification called mutual fund shares. Such shares have the quality of "requiring the company issuing to accept, at the demand of the holder . . . and at prices determined and payable in accordance with the conditions, the surrender of the shares . . . that are fully paid." [110] It is still for the fund, however, to delineate the conditions under which shares would be redeemed.[111] The law does not so much change existing conditions for federally incorporated funds as it clarifies industry practice. Before 1965, federal funds were incorporated in much the same manner as those in On-

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[106] Special provision has been made for fund reporting. They largely duplicate that which the Ontario Securities Act in its 1968 amendments requires. *See* Corporations Amendment Act, 1968, ONT. STAT. c. 19, § 6 (1968).

[107] The Corporations Act, ONT. REV. STAT. c. 71 § 27(3) (1960) allows a fund to redeem its own preferred shares. Section 27(6) provides for such redemption out of a fund set aside for that purpose at a price reflecting the market value.

[108] Once the preference, which can be minimal, has been established the fund may eliminate voting rights. The shares, after all, are not common, but special. To the extent that a fund operates with complete freedom from shareholder restraint it obtains greater flexibility in investment decision.

[109] Business Corporations Act, 1970, BILL No. 61, 3d SESS., 28th LEG. § 37 (Ont. 1970). The bill was introduced by the government.

[110] Canada Corporations Act, CAN. STAT. c. 52, § 12(A)(1) (1965), *amending*, Companies Act, CAN. REV. STAT. c. 53 (1952).

[111] Canada Corporations Act, CAN. STAT. c. 52, § 12(A)(2) (1965).

tario, through the use of special shares. Illustrative of the lack of change are the relatively few funds already incorporated federally which filed supplementary letters patent two years after the Canada Corporations Act had been amended to cover mutual fund shares. By 1967, only six of the 24 funds which were federally incorporated before 1965 had sought reclassification,[112] while each of the eight funds incorporated after 1965 made use of the proviso for mutual fund shares.

There may be some added meaning in the failure of so many pre-1965 federal funds to modify their letters patent. These funds continue to restrict redemptions to monies available through reserves and capital surplus. The 1965 amendment would allow them to redeem out of capital at net asset value. For many funds, this opportunity has been rejected by implication. The funds retain the flexibility to restrict redemptions, and the Canada Corporations Act is as permissive as the legislation in Ontario.

The question remains whether the funds should retain this absolute right of control over redemption policy. An agency such as the Ontario Securities Commission could regulate on the same basis as it has laid down management fee scales; it is not clear, however, whether any legal basis for such regulation exists.

In the United States, the Investment Company Act of 1940 took a firm view on the matter of redemptions, and no registered investment company was given the right to suspend redemptions. The statute defined the situations in which redemptions could be suspended: (1) if the New York Stock Exchange is closed for reasons other than customary weekend and holiday closings; (2) if trading on the New York Stock Exchange is restricted by the Securities and Exchange Commission; (3) if disposal of a fund's securities is not reasonably practicable; (4) if emergencies impede a fund from fairly determining the value of its assets; and (5) if the SEC permits such suspension for the protection of the securities holders of the fund.

In its 1966 report on the *Public Policy Implications of Investment Company Growth*, the SEC did not seek to broaden its powers in the matter of fund redemptions,[113] despite the growing institutionalization of the stock market;[114] however, the law had imposed an obligation on the funds to redeem and agency discretion in permitting exception to

[112] Those funds which changed their shares to "mutual fund shares" were: American Growth Fund, Ltd.; Dominion Equity Investments Ltd.; Executive International Investors Ltd.; Grouped Income Shares Ltd.; Regent Fund Ltd.; and Savings and Investment Corporation Fund Ltd.

[113] SEC STUDY, *supra* note 98, at 300.

[114] *Id.*

that rule was severely limited. The Commission was not to act as a market regulator. Apart from limited, emergency powers, the Commission did not have the responsibility for controlling price fluctuations in the securities markets.[115]

In Canada, the legal reality of fund redemption policy stands in a radically different posture than in the United States. For the Canadian fund manager, that policy has built-in flexibility. Individual rules can be set that will permit the fund to pursue investment goals without the threat of a run and a corresponding need to liquidate holdings at a substantial loss; the absence of law leaves each fund free to shape varying approaches to redemption. This apparent freedom, however, is somewhat limited by the certain reaction of the investing public if any fund were to use its legal right to restrict redemptions.

These realities not only were recognized by the Canadian all-government Committee report; they were also met with meaningful analysis and recommendations. Illustrative is the report's view of a fund as a long-term investment. Short-term traders were to be penalized in making any redemption demand.

> We have concluded that any purchaser of shares or units to a value in excess of $50,000 should be subject to a penalty, payable to the mutual fund by reduction of the redemption price, of 4% of his redemption price if he redeems his shares or units within 90 days, and of 2% of his redemption price if he redeems his shares or units within six months.[116]

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[115] *Id.* Recently, and significantly, the SEC permitted Mates Investment Fund, Inc. of New York City to suspend the right of redemption because a "substantial portion of the funds portfolio" was held in lettered stock of Omega Equities, Inc. which had been the object of a 10-day trading suspension order by the Commission. Omega, an over-the-counter stock, jumped from 60-70 cents a share on April 30, 1968, to $33-35 by December 9, 1968. On June 12, 1969, two months after Omega trading once again was permitted, the SEC lifted its suspension of redemption in Mates' fund shares. On July 17, 1969, Omega filed a registration for a public offering. SEC File No. 2-33896. Following the SEC order sales and redemptions of shares resumed on July 23, 1969, for the Mates Investment Fund, Inc. A "cool it" attitude apparently characterized investors in the Fund at that time. According to the Fund, holders asked for redemptions of about $1 million worth of the approximately $8.5 million portfolio, or about 11.3 percent.

A shareholders meeting on Monday, July 21, 1969, approved the following resolutions: a new advisory agreement with management; selection of accountants ratified; reimbursement of the Mates Management Company for $165,000 expenses; increased number of authorized shares fourfold (from $5 million to $20 million). A spokesman for the Fund characterized the shareholders as showing an "amazing lack of antagonism." N.Y. Times, July 23, 1969, at 56, col. 7.

[116] MUTUAL FUND COMMITTEE REPORT, *supra* note 1, at 492. The report agreed to the payment of redemption with underlying securities, if the shareholder agreed. In the

SUMMARY: THE LAW AND MUTUAL FUNDS

Canadian law permits the mutual fund industry great latitude to invest in the equity market as individual business interests dictate. In areas such as taxation, freedom has come through nonenforcement of statute. In other areas, fund behavior has been left unstructured because of agency ambivalence; note, for example, the Ontario Securities Commission's timid attempt to regulate through control over the prospectus. Finally, there are instances where the law has permitted the industry to pattern its own standards. The Canada Corporations Act takes this approach in the area of redemptions.

Whatever may be the limitations and purposes of the law regarding mutual funds in Canada, the industry itself has acted to form rules of conduct binding on its members. These rules not only are law, in the sense of binding announced standards of conduct; they also provide considerable insight into how the individual members of the industry enact their role. Moreover, they provide insight into how the industry thinks it should function.

PROFILE IN ACTION

A CONTEXT FOR SELF-REGULATION

Industry self-regulation takes place in a specific context: restraint will not be self-imposed unless it serves the individual member's own ends as well as those of his industry. To the extent that the restraint conflicts with the profit motive, it is possible that the prohibition will be ignored or circumvented. Thus, in order to evaluate the breadth and effectiveness of fund self-regulation, it is necessary to understand fund motivation, which is a function of the fund's structure, and the relationship between this motivation and investment in the equity market. A fund must enhance the market value of its portfolio or risk the danger of decreased sales of fund shares coupled with increased demand for redemptions which could cause a fund to liquidate portions of its holdings.[117] Thus, fund motivation is predicated upon performance and

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absence of such agreement the report recommended approval be obtained from the relevant securities administrator. *Id.* at 497-500.

[117] Professors Quirin and Waters recognized the problem. They wrote: "The danger is simply that, if a fund were faced with a severe market slump and a run of redemptions, it might not be able to sell shares and reduce indebtedness quickly enough to have anything left for the last few shareholders." They added, however, "[W]e regard these dangers as remote . . . and the use of moderate leverage as virtually harmless, especially in view of the fact that investor risk is probably greater in certain unlevered funds than in other levered ones." *Paper* 12, *supra* note 99, at 12-3.

liquidity. Indeed, it is possible for a fund bent on performance to erode its position of liquidity.

A conflict between these two goals arises through the means used to measure performance. Specifically, performance is based upon valuation of fund shares. If a fund share cost $10 last week and can be redeemed for $40 today, the fund is "performing." A shareholder cares little about what that $40 represents; from his point of view, $10 wisely invested has brought $40. There is difficulty, however, in measuring performance and in accepting the method for valuing underlying shares.

Money for the redemption of shares is generally provided by cash flow and not by the liquidation of investment. The valuation of a fund's underlying investment and, hence, the value of each fund share, which is determinative of fund performance, is calculated on a day-to-day basis upon the stock market quotation.[118] The larger funds may invest between $1.5 and $3 million in any given issue,[119] and investment of this sort cannot be liquidated easily; however, since redemptions are made from funds received for newly purchased shares, this lack of liquidity will not deleteriously affect the fund's ability to redeem its shares so long as the fund continues to attract new investors by performing well. Problems may arise, however; for example, if the fund takes a long-term position, or even a short-term loss with a view toward a long-term gain, fund performance, essentially a day-to-day phenomenon, may decline with a resultant decrease in cash flow through sales and an increase in redemption demands.

The "speculative" fund is a recent innovation,[120] meeting the needs of those with growing incomes who want to maintain their worth in an inflationary economy. The speculative funds, five of which are represented in the Canadian Mutual Funds Association (CMFA), have been highly successful in attracting the savings dollar, even though they have only a small part of the industry's assets. As a result of performance ranging up to an annual increase in value of 100 percent, they are making a sizeable and increasing proportion of the industry's new fund sales. In 1968, speculative funds had net sales of $105.2 million; in the same

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[118] Difficulties, of course, are encountered by those funds which have purchased "letter stock," that is, shares coming from a primary distribution of what may be an unseasoned company. How should such an issue be valued? If acquisition cost is used, the issue may be substantially undervalued. If market value is used, the issue may be overvalued since it remains illiquid. Professors Quirin and Waters feel such an issue "should reflect a percentage discount from the prevailing market price not less than the discount at which [it was] acquired." *Id.* at 12-9.

[119] *Paper* 13, *supra* note 95, at 13-3.

[120] *Paper 2: Competition in the Canadian Mutual Funds Industry*, in QUIRIN & WATERS, A STUDY OF THE CANADIAN MUTUAL FUNDS INDUSTRY 2-26 (1969).

year, all other CMFA members' net sales totalled only $102.3 million.[121] These figures at least raise the questions of whether the fund investor is aware of the increased risk and whether the larger funds will respond to the increased competition and in what manner.

A possible indication of industry concern came in the form of an address by Mr. R. H. Jones, Vice President, Securities Investment Division, The Investors Group, on April 21, 1969. An officer of Canada's largest fund complex, Mr. Jones noted that speculative funds represented a departure from traditional investment philosophy by emphasizing short-term over long-term gain. Mr. Jones also expressed concern with a definition of fund performance which is based on out-performing competing funds; although not defective from a conceptual viewpoint, this definition can lead to the sort of setbacks that a fund manager must avoid and could result in increased regulation of the fund industry in order to curb speculative excesses.[122]

The emphasis on short-term comparative performance—an emphasis necessary for the survival of a speculative fund—does represent a departure from a philosophy of investment which pre-dates the speculative fund and which permitted a fund to accept temporary setbacks in order to buy value which would eventually bring satisfactory investment return. Despite this change in investment philosophy, however, neither Mr. Jones, nor the Chairman of the Ontario Securities Commission, nor the President of the Toronto Stock Exchange saw any need to check the growth of the speculative fund. The Chairman of the Ontario Securities Commission felt that the only need was for more frequent fund reporting.[123] The President of the Toronto Stock Exchange recognized that because of their size some funds could bring pressure to bear on selected issues, but he felt that this simply reflected supply and demand and saw no effort being made to create pools of money for the purpose of market manipulation, similar to those established in the

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121 *Id.*

122 Address by R. H. Jones, Vice President, Securities Investment Division, The Investors Group, before the Winnipeg Rotary, April 21, 1969. *See also* MUTUAL FUND COMMITTEE REPORT, *supra* note 1, at 62-63.

123 Chairman H. E. Langford said:

> Institutions are the largest single factor in the stock market and recent activity in the Canadian market is due to fund transactions. There is growing concentration in Canadian issues recently. The greater activity of U.S. funds and institutions in more speculative issues can be seen in increased portfolio turnover. We are giving thought to the question of whether more frequent reporting of fund portfolios might not be in the public interest.

The Globe & Mail, Sept. 5, 1968, § B, at 5, col. 1.

1920's. Indeed, the Exchange President saw institutions generally as a stabilizing influence on the market.[124]

The approach of the speculative funds stands in conceptual contradiction to the formal policies of the Canadian Mutual Funds Association relating to investment restrictions. At their root, CMFA policies attempt to strike a balance in favor of safety through the vehicle of investment diversification. For the speculative funds, some of which are not members of the CMFA, such restraints can inhibit performance. Thus, competitive pressure can be exerted to ease rather than tighten existing regulation. Professors Quirin and Waters argued for upward, more liberal regulations in their 1969 report,[125] even though 1968 CMFA amendments already had eased investment restrictions.

New competitive pressures have an effect on the nature and effectiveness of self-regulation. The CMFA is an association with no statutory base and exists at the desire of members of the industry and not because of government fiat. As an association, it has the power to fine, censure, suspend, or expel a member,[126] such powers being exercised on occasion. In one instance, the CMFA's executive director, acting immediately and without seeking executive committee approval, warned a fund that it had exceeded the allowable limit of investment in a single company. Within a few weeks, the matter was corrected. Through consultations with the CMFA's Executive Committee, the same fund was cautioned to avoid possible conflicts of interest through purchase of short-term paper from an institution controlled by a fund insider.[127]

The CMFA can shape enforceable rules of conduct. In terms of investment restrictions, however, unless the goals to be achieved are reasonably clear and unless there is a public policy formalized through law, loose and changing interpretations can be expected as a response to competitive pressures. The problem, therefore, is to delineate or categorize the questions that each fund and the Association must answer

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[124] *Id.* at col. 4.

[125] *Paper* 12, *supra* note 99, at 12-7.

[126] These sanctions apply, *inter alia*, for the violation of *any* Canadian Mutual Fund Association regulation. Complaint may be made by any Canadian Mutual Fund Association member or *any person*. If the Canadian Mutual Fund Association Executive Committee finds grounds for probable cause, after appropriate notice, a hearing will be held and explanation requested from the charged member. On a finding of guilt, opportunity for appeal to the full Canadian Mutual Fund Association Board of Directors is allowed before sanctions may be imposed. The nature of that appeal is one in which the Board has before it "all relevant correspondence" together with the Executive Committee's recommendation. Again, explanation by the charged member is permitted. CMFA By-Laws No. 13—Business Conduct, *as amended* (May 17, 1966).

[127] Interview with Michael Bell, Executive Director, CMFA.

in formulating meaningful criteria for investment restriction. In doing this, the limitations of the CMFA must be stressed. For one, it is not fully representative of the industry. On December 31, 1968 its membership consisted of only 41 of the 136 mutual funds qualified for sale in Canada and of only 14 of the 92 management companies associated with such funds. Yet, though representing a minority of funds, CMFA members controlled 86 percent of industry assets.[128] The Canadian Committee on Mutual Funds noted that the members of the CMFA "have certain common characteristics. Every mutual fund which belongs to it is sold subject to a basic sales charge in excess of 8%. Most of these mutual funds are distributed primarily or exclusively through direct sales forces . . . ."[129] The CMFA's recommendations may be considered by provincial securities commissions; nevertheless, the CMFA may not represent the entrepreneurial motivations of smaller and newer mutual funds.

CMFA'S INVESTMENT RESTRICTIONS

On their face, the CMFA's investment restrictions are fairly inflexible regulations. They require that every fund disclose its investment restrictions in its prospectus,[130] a point obviously covered by Ontario's prospectus requirements. There are absolute prohibitions upon the purchase of warrants[131] and the purchase of securities of its management company, underwriter or contractual distributor.[132] There also are restrictions on margin buying, selling short,[133] and borrowing money.[134] The mortgaging or pledging of assets in excess of 10 percent of net fund value at market is also prohibited.[135]

More interesting, perhaps, are the detailed provisions relating to equity investment. Before 1968, member funds were forbidden from using more than 10 percent of fund assets in the purchase of any security except obligations guaranteed by either the Canadian or United States govern-

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128 MUTUAL FUND COMMITTEE REPORT, *supra* note 1, at 727.

129 *Id.* at 728. The committee further noted that "[n]o mutual fund organized outside Canada belongs to the CMFA. Until early in 1969, its membership consisted entirely of Canadian-organized mutual funds, their management, and distribution companies. Early in 1969, one independent sales force was admitted to membership."

130 CMFA Regulations, Rule 5 (Apr. 1964).

131 *Id.* Rule 5(a).

132 *Id.* Rule 5(d).

133 *Id.* Rule 5(b).

134 *Id.* Rule 5(a). "Every mutual fund . . . shall not borrow money for any purpose nor mortgage nor pledge any of its assets to an amount in excess of 10% of its assets at market."

135 *Id.*

ments, and no fund could own more than 10 percent of any portfolio company's outstanding issue.[136] In May 1968, the rule was revised to allow funds to acquire more than 10 percent of a portfolio company's outstanding issue if certain conditions were met. Two principal conditions were: (1) the fund's total investment in the portfolio company could not exceed five percent of the fund's net assets[137] and (2) the fund in no event could acquire more than 10 percent of a portfolio company's outstanding voting stock.[138]

The revised rule has significant meaning for large funds seeking Canadian investment outlets. A large fund may stay within the five percent asset limitation and still obtain 10 percent of a desired corporation's outstanding voting stock, in addition to significant holdings in the same corporation's nonvoting stock; moreover, if the listed stock is nonvoting in the first instance, a fund may exceed the 10 percent limitation so long as no more than five percent of assets are employed. Thus, the new rule permits the large fund to maintain certain economies of scale by limiting the number of its investments, thereby providing more effective portfolio management. As a general rule, larger Canadian funds have minimum investment guidelines which statistically indicate that they expend $1.5 to $3 million in any given security.[139] At present, this dollar expenditure usually results in individual investments equal to about one percent of fund assets.

A brief survey of fund industry structure underscores the significance and need for encouragement of increased equity purchasing. In assessing institutional impact on the equity market, the existence of giant entities cannot be ignored. Using data obtained from the *Financial Post Survey of Investment Funds, 1961-1968*, Professors Quirin and Waters computed the dollar assets of the eight largest management companies to be $2,135 million, compared to over-all industry assets of $2,716 million. Of these eight, the largest management company had $915 million by the end of 1967 and the two largest companies had $1,316 million.[140]

In 1968, it became fairly obvious that the funds were not tied to the Canadian equity market. Whenever they found it to their advantage, they could and did invest in the United States. By December 31, 1962, CMFA funds had invested $144.1 million in United States and foreign assets. By December 31, 1967, that figure had risen to $1,008 million,[141]

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136 *Id.* Rule 5(c), *as amended* (May 1968).
137 *Id.* Rule 5(f)(ii).
138 *Id.* Rule 5(f)(iii).
139 *Paper* 13, *supra* note 95, at 13-3.
140 *Paper* 2, *supra* note 120, at 2-9.
141 *Id.* at 14-3.

nearly half of total industry assets, yet no fund held five percent or more of any United States portfolio issue. This fact gives some clue to the motivation behind Canadian fund foreign investment. At the end of 1967, United Accumulative Fund Limited, one of the two largest funds in Canada, had 8.3 percent of its assets invested in International Business Machines, however, this was less than one-tenth of one percent of IBM's outstanding stock. United enjoyed at least potential benefits from its investment: it was able to place significant sums in an industry that had not yet fully developed in Canada and it had secondary liquidity in that investment,[142] due to the relatively free turnover of IBM stock.

Putting aside issues concerning national politics and dollar-drain, the funds have the opportunity to invest in what amounts to a North American market and this helps to explain the import of the broadened CMFA investment rule. Canadian funds are not compelled by economic considerations to buy Canadian equities. Due to the extent of which nonCanadian investment alternatives are available, the inference may be drawn that the larger funds sought a broadened rule to take advantage of what they considered good investment opportunities which happened to be Canadian. If the CMFA rule had remained the same, the funds would have pursued other investments and would not have been compelled to invest in questionable Canadian issues. Before the 1968 CMFA revision, the pursuit of other investments brought member funds very close to the maximum investment permitted, both in terms of percentage of outstanding portfolio issue and in terms of percentage of fund assets placed in a particular issue.[143]

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142 Some 64 percent of present holdings of U.S. stocks by Canadian funds are accounted for by domestic funds, the remainder by specialty funds; the former accounted for 65 per cent of all purchases over 1962-67 and for 64 per cent of purchases during 1967. Unlike the holdings of the specialty funds, holdings of U.S. securities by domestic funds represent the consequences of decisions taken by portfolio managers. Informal discussions with some portfolio managers suggest that there are at least two reasons for holding U.S. securities, both of which could account for a deliberate shift into such securities by a growing fund:

(1) the greater liquidity offered by U.S. security markets;

(2) opportunities offered by the U.S. market for investment in industries which are not available in the Canadian market, but which have characteristics making them a desirable addition to a portfolio.

A third possible reason—not mentioned in any of the discussions—but which would seem equally valid, is to take a position in U.S. dollar assets in order to provide a hedge against possible devaluation of the Canadian dollar relative to the U.S. dollar. Such a hedge is provided by any holding of U.S. securities. However, a better one is provided by holdings of shares in Canadian companies whose sales are made in the U.S. at U.S. prices but whose expenses are incurred in Canada at Canadian prices. The pulp and paper and certain base metal industries are examples. *Paper* 14, *supra* note 40, at 14-11.

143 *See* Appendix.

The tables show that often an expenditure of less than one percent of fund assets enables the larger Canadian groups to acquire gross positions of 20 percent or more in portfolio holdings. Markborough Properties, Ltd. provides a case in point. With .5 percent of its assets, United Accumulative obtained 6.9 percent of Markborough's outstanding common, and with .1 percent of fund assets, warrants to purchase 20.8 percent of Markborough's common. With only .9 percent of fund assets, Investors Growth Fund purchased 31 percent of F.P.E. Pioneer Electric's Class A shares.

On these facts, it is clear that a relatively small expenditure of total assets by the larger Canadian funds may result in major positions in issues of companies with a small equity base. It follows that smaller Canadian funds have comparable potential. For example, Canadian Gas and Energy Fund Ltd., which ranked below the eight largest Canadian funds in 1967,[144] used 8.9 percent of its assets to acquire 3.8 percent of Home Oil Company's Series B stock.

SIGNIFICANCE OF FUND HOLDINGS: LIQUIDITY AND MOBILITY

When a portfolio company is on the rise, there are obvious advantages which inure to the heavily committed fund insofar as it shares proportionately to its holdings in the company's good fortune and may tend through its heavy share holdings to stabilize price; morever, a fund's performance is measured by the market value of its holdings and to the extent portfolio share price goes up, fund management can expect greater sales and the investment advisor will receive a greater return.

Regardless of the difficulty in unloading heavy share positions, most funds need not fear a rash of redemption demands, even in a falling market. Historically, fund sales have exceeded redemptions. This fact is illustrated by monthly figures over a two-year period for Investors Growth and United Accumulative.

*SALES AND REDEMPTION OF FUND SHARES**

INVESTORS GROWTH FUND OF CANADA LTD.	DOLLAR AMOUNTS THOUSANDS	
Month and Year	*Sold ($)*	*Redeemed ($)*
1966		
January	3,366	735
February	4,446	777

[144] *Paper 2, supra* note 120, at 2-13.

* Source: Canadian Committee on Mutual Funds and Investment Contracts.

INVESTORS GROWTH FUND OF CANADA LTD.	DOLLAR AMOUNTS THOUSANDS	
Month and Year	*Sold ($)*	*Redeemed ($)*
1966		
March	3,799	838
April	2,427	638
May	4,872	926
June	3,633	807
July	2,968	594
August	6,182	575
September	6,456	891
October	2,158	1,004
November	3,288	715
December	2,253	673
1967		
January	3,213	1,029
February	4,703	1,231
March	2,805	1,516
April	3,028	1,490
May	4,517	2,015
June	3,751	2,053
July	3,762	1,393
August	9,523	1,364
September	7,849	1,784
October	3,958	2,013
November	6,762	2,349
December	4,557	2,057

*SALES AND REDEMPTIONS OF FUND SHARES**

UNITED ACCUMULATIVE FUND LTD.	DOLLAR AMOUNTS THOUSANDS	
Month and Year	*Sold ($)*	*Redeemed ($)*
1966		
January	8,961	1,042
February	9,194	1,121

* Source: Canadian Committee on Mutual Funds and Investment Contracts.

UNITED ACCUMULATIVE FUND LTD.	DOLLAR AMOUNTS THOUSANDS	
Month and Year	*Sold ($)*	*Redeemed ($)*
1966		
March	13,497	1,177
April	7,258	1,497
May	10,582	1,356
June	6,499	1,750
July	5,479	1,468
August	6,620	1,947
September	8,430	1,197
October	5,067	1,591
November	6,248	1,413
December	3,900	1,744
1967		
January	4,721	2,595
February	4,577	3,461
March	7,259	3,921
April	4,056	4,570
May	5,129	5,010
June	5,260	5,161
July	5,048	3,052
August	6,591	3,248
September	8,589	3,341
October	5,231	3,839
November	6,938	3,632
December	4,837	3,968

Should a fund find itself in need of additional monies to take advantage of current investment opportunities, there is that resource which Professors Quirin and Waters have called secondary liquidity, which frequently consists of American issues such as IBM.[145] Furthermore, a fund can borrow against its assets to a limited extent.[146] If there is a problem of liquidity or mobility, it is not apt to be found in general fund performance so much as in the particular portfolio holding. As of December

[145] *Paper* 13, *supra* note 95, at 13-2.
[146] *Paper* 12, *supra* note 99, at 12-3.

31, 1967, no Canadian fund had followed a policy of investing most fund assets to acquire concentrated positions. Without exception, only the larger fund complexes took five percent or more of any Canadian issue and, these larger funds, Investors Growth and United Accumulative, maintained a balance in terms of share sales and secondary liquidity.

In this context the statistics are inconclusive as to the consequences of individual share concentration. A random summary of the volume of trading in relation to outstanding shares in some of those issues where funds have concentrated holdings produces a broad range of figures. Using 1967 as the sample year, Union Oil Company of Canada Ltd. with 4,785,000 outstanding shares had only 139,557 shares traded, accounting for 2.9 percent of the total. One of the smaller Canadian funds, Natural Resources Growth Fund Ltd., using 9.71 percent of assets, held .42 percent of Union's outstanding common at the end of 1967. Though limited in percentage of holding, this rather small fund certainly had a potential to influence the price of Union common. If it so desired, it could have accounted for nearly 20 percent of trading. Next, consider Markborough Properties Ltd. with outstanding shares of 3,647,094 and 1967 year-end trading of 316,479, or 8.7 percent of the total. In the same period, two funds held 16 percent of Markborough's outstanding common, or twice the 1967 trading volume. Finally, at year-end 1967 one fund with .8 percent of its assets held 7.6 percent of Steinbergs Class A, the only issue traded. In the same year with 3,715,639 shares outstanding, Steinbergs had traded 201,747 shares, or 3.4 percent of the total.

Where a fund finds itself with heavy holdings in a company whose issue it no longer desires, the price of selling out might be very high indeed. It is even possible to argue that in a falling market where the issue is thin—where there is a small equity base—buyers simply may not be available for large blocks of stock. Whatever the arguments may be, however, fund statistics for 1962-1967 provide few examples of locked-in situations. The best example is Steinbergs where in 1964 two fund complexes, consisting of three funds, held 20.33 percent of the company's Class A stock; this was an investment in the retail food industry which institutions found a few years later, due to the intensity of competition, to have had a blunting effect on profit.

Steinbergs was incorporated in Quebec in 1930. In 1958, Steinbergs had made a public offering of a nonvoting issue, which enabled the raising of capital without the dilution of control. The issue was fully subscribed. By the end of 1964, the mutual funds held 20.33 percent and accounted for 26.89 percent of the trading in Steinbergs stock. By 1965 the funds had increased their position in Steinbergs to 23.8 percent. There was little change in 1966 when the funds maintained their position at 23.50 percent; however, in 1967 the funds sold a substantial portion of their holdings and at the end of 1967 their holdings were reduced to 14.58 percent, fund trading having accounted for over 20 percent of the total trading in the stock.

The 1967 reduction in Steinbergs holdings by the funds amounted to 40 percent. Profits had increased from 1963 to 1966, and earnings per share had risen from $.80 in 1963 to $.89 in 1964, $1.05 in 1965, and $1.11 in 1966.[147] In 1967, profits remained at $1.11.[148] By 1968, Steinbergs finally reacted to the squeeze of competition by establishing discount food operations and by diversifying through the operation in Quebec of four experimental drive-in restaurants.[149] Unwilling to risk a turbulent future, some of the funds were able to sell out at a loss. Another fund eliminated only a portion of its holdings at a profit.

At one point a few funds had held 20.33 percent of Steinbergs' nonvoting issue; however, they were not locked in and in one year were able to cut their holdings by 40 percent. Steinbergs was not a failing company but was reacting to the profit squeeze. Statistics offer no illustration of simultaneous fund liquidation of fund holdings in a company whose fortunes are clearly falling. This may attest to the prudent investment judgment of the fund; however, it remains an unanswered question as to what would have happened if the three funds investing in Steinbergs simultaneously had opted out. The "in-out" performance fund was not a significant force in Canada in 1967, and each of the three funds had long-term investment objectives.

SIGNIFICANCE OF FUND HOLDINGS: PORTFOLIO CONTROL

Although Steinbergs Class A is listed on the Toronto Stock Exchange, it is nonvoting. Indeed, for all practical purposes it must be considered nonvoting common since the preference which it has is negligible. The lack of a vote, however, did not deter the funds from buying Steinbergs. Similarly, the fact that other issues are also nonvoting "common" has not inhibited purchase by the funds. Examining the two largest fund complexes in Canada, one finds significant sums allocated to such issues. At the end of 1967, United Accumulative had $27,976,596, or

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[147] *Financial Corporate Service.* "Steinbergs Five Year Quick Reference Summary," March 4, 1968.

[148] *Id.*

[149] Financial Post, Sept. 28, 1968, at 24, col. 2.

7.8 percent of its total investment portfolio, placed in nonvoting common. The monies were placed in nine issues. United's position in these stocks rose from an initial expenditure in 1962 of $1,284,375 to a figure 27 times greater in 1967. At the end of 1967, Investors Mutual had nonvoting common valued at $17,621,808, or 3.1 percent of its total investment portfolio. This reflected a rise of more than four times the 1962 figure of $4,614,282. By 1967, Investors' holdings had been reduced to five nonvoting issues.

The extent of these holdings indicates, to some extent, the degree to which desire for control of portfolio companies influences fund investment. Responding to detailed questioning by the Canadian Committee on Mutual Funds and Investment Contracts, not a single fund indicated an interest in investing for control.[150] No fund indicated a desire to substitute its business judgment for that of portfolio management as a matter of policy. If the policies of a portfolio company are contrary to what the management company believes necessary, the security will be sold. Almost without exception, the funds refuse to acknowledge a need to vote their holdings; proxies either are returned in favor of management proposals or they are not voted, the funds ultimately relying on the market for recourse.

In making investments, funds necessarily consider portfolio management. A company would not normally become a portfolio company unless fund management was prepared to vote with the management of the company. When this is no longer true, the fund sells its shares in the company.[151] Yet, many funds acknowledged that life with portfolio companies is not simply a question of selling or holding. There is often dissatisfaction with the policy or actions of the management of these companies, but it is weighed against those areas in which there is satisfaction.

From the answers submitted by the funds, it became clear that the availability of a market and the possibility of sale was sufficient to insure discussion and even negotiation between portfolio and fund manage-

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[150] The questions asked the mutual funds concerning portfolio relations by the Canadian Committee on Mutual Funds and Investment Contracts concerned the following areas: holdings in portfolio companies; policy concerning officers', directors' and employees' activities in portfolio companies; participation in organization of portfolio company; participation in portfolio company financing or mergers; participation in portfolio company operations; attendance at annual and special meetings of portfolio companies; use of proxies; action when dissatisfied with portfolio company policy; joint action to influence portfolio companies.

[151] The same fund added, however: "Of course a situation could arise in which the sale of a security was impossible or difficult, and in which a change of directorship would be desirable from a standpoint of fund shareholders."

ments. From the fund that said it lived with dissatisfaction came the admission that in 30 percent of the instances when it became dissatisfied there was an attempt to influence management change. In the remaining 70 percent, the fund liquidated its holdings. Seldom did the fund use its vote or attend annual meetings. The lack of fund attendance is hardly surprising, however, in light of the scant opportunity at these gatherings for fruitful discussion of company prospects at a sophisticated level.[152]

Fund influence upon the management of portfolio companies is often brought about not by the possession by the fund of a large block of votes, but, rather, through the market effect implicit in the disposition by the fund of a large quantity of the company's stock. This is especially true, for instance, when the stock that the fund holds is nonvoting and the quantity held makes easy liquidation impossible. In most instances, the influence that the fund exerts in this manner is through the company's fiscal agents or through analysts who have a close relationship to the company's management.

Funds are institutions which are designed to provide an increased flow of funds into the equity market and, insofar as influence on management is concerned, they should be distinguished from the occasional investor. Their influence on management of the public corporation transcends particular fund holdings. Funds will have a continued impact on the market, and the larger the fund, the greater the impact. Moreover, the larger funds, having more monies in each portfolio company than the smaller funds, find a greater need not only to initiate discussion but also to respond to portfolio problems of a given type. Accordingly, four out of the eight largest Canadian funds reported instances in which efforts were made to influence portfolio management. The four represented more than half of the industry's assets; however, 52 of 58 reporting funds indicated no instance of such an attempt being made.[153]

A pattern of action has emerged where influence has been exerted. The larger funds, however, do not want to run the day-to-day opera-

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[152] The fund continued: "However, exceptions are made, especially where unusual developments appear possible, or where the company offers a particularly good opportunity for the analyst to meet executives informally at greater length after the meeting . . . . There has been no change in the management company's policy since 1962."

[153] The 52 stated that they had neither volunteered nor been consulted during the period surveyed by the Canadian Committee on Mutual Funds and Investment Contracts (1962-67) regarding dividend policy or any other aspect of portfolio company management.

tions of a portfolio company.[154] Part of their decision to buy an issue rests in their confidence in management. Thus the funds use influence only to protect their investment. From the answers received, a summary categorization has been prepared that delineates areas of fund concern.

The first of these areas is portfolio company financing and mergers. Funds have frequently been consulted by portfolio companies concerning a proposed offering,[155] and quite often their recommendations have been accepted. One of the larger funds kept records which noted six instances between 1964 and 1967 when advice was given relating either to the financing of new issues or to the terms of a merger affecting a company in which the fund held stock. In five of the examples listed by the fund, inquiries were initiated by the company considering the public offering. In each of the five company-initiated efforts, the fund made recommendations which were accepted and, with a limited expenditure of monies, acquired major positions once the questioned issue was made public.

Funds with large holdings have an important stake in merger activities. They are interested in the merger being favorable both in terms of the new enterprise to be formed as well as the formula for any exchange of stock. Canadian funds have not only consulted portfolio management as to modification of some merger conditions, but on occasion they also have helped to organize opposition to the merger itself. Together with a U.S. institution, two of Canada's largest funds sought

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[154] An example of stock liquidation by a large fund given to the Canadian Committee on Mutual Funds was:

> More recently (1968) we disposed of part of our holding of [XYZ, a U.S. company] because of a growing concern as to the competence of management which has been indirectly relayed to the [fund] through third parties. This company appears to have lost complete control of costs in the final quarter of its fiscal year, having stated publicly in a press release that they anticipated "good year for earnings" three weeks after the fiscal year end only to contradict themselves a few weeks later with the publication of poor results indeed. In this instance, we intend to support any move by another corporation to acquire [XYZ] and thereby recoup part of the capital loss sustained as a result of management's apparent incompetence.

[155] This is a well established function for the management companies of funds and fund companies. They play the role of investment bankers. Not infrequently they hold positions of long-term relationship with the portfolio company. *See* United States v. Morgan, 118 F. Supp. 621 (S.D.N.Y. 1953). In *Morgan,* the United States alleged that the 17 defendants had conspired to monopolize the securities business in violation of the Sherman Act §§ 1, 2, 15 U.S.C. §§ 1, 2 (1964). The court held that the evidence was insufficient to establish that the 17 investment banking firms had used the syndicate system of underwriting and distributing securities as a conspiratorial device in connection with an integrated over-all combination in violation of the antitrust laws.

to block a merger between two giant U.S. corporations. They were unsuccessful in part because another fund elected to settle for cash for its 10 percent position, receiving a greater cash amount than any other institutional investor was able to obtain from the acquiring corporation.

A second area of concern is the accounting practices by portfolio corporations upon which funds must be able to rely. The failure to follow accepted procedures could distort the profit picture. An example of fund action in this area occurred in 1965 when a fund advised one of its portfolio companies to change to a nationally known auditing firm.

A third area of concern is the portfolio company's dividend policy; however, fund action has been taken only when the company's policy has caused the fund concrete policy problems, and the consensus among the funds is that their views carry only minimal weight in this area. One large fund reported that since January 1, 1966 the only instance of influence being exerted on the dividend policy of a portfolio company occurred when a dividend date, which normally fell at the end of the year, fell early in 1968. This caused embarrassment since fund accounting uses ex-dividend dates to bring in fund income, and the income from that dividend was helping to maintain investment company status for calendar year 1967.

A fourth area of concern to the mutual funds is the selection of portfolio company directors and officers, although during the period 1962-1967 funds seldom sought directorships and rarely exerted influence upon the company through possession of large blocks of votes. However, fund officials, particularly in the larger enterprises, were asked to be directors or to suggest candidates. One fund reported three examples of requests for suggestions by Toronto Stock Exchange listed corporations, and in each instance where its advice had been sought it had been accepted.

One frequently cited reason for seeking advice from the funds is their financial expertise. For example, a private company, considering a public distribution at a formative stage in its corporate existence, came to the X Fund and asked X's management for advice and to nominate one of its key people to the corporation's board. The fund was interested in the corporation, but it recognized the risk-taking venture of the company and the fact that a public market had yet to be established. The fund placed a member of its management on the board, and later took a major position in the public issue of the corporation; thus, the fund had an interest in the continuing success of the company. It endeavored to insure not only a proper scheme of financing, but also management continuity and corporate concentration in those areas of greatest profit-ability. Fund directors are also sought by companies with seasoned securities.

Among certain funds, there is concern over naming directors to other corporations since embarrassment might result if a decision were made to sell the portfolio issue. One of Canada's largest funds, however, reported that it had nominated one of its managing directors to the boards of a number of other corporations, subsequently selling its holdings in each, and its nominee had remained a director of each corporation.

Responding in 1968 to information requested for 1962-1967, a smaller fund briefly stated that occasionally one of its directors or those of its management company had become a director of a portfolio company. In each instance, the reason for this had been to provide the fund access to information about the progress of the company's business, thus benefitting both the portfolio company and the fund's shareholders; furthermore, there is no specific written code of ethics with reference to this sort of situation even though there is no distinction between the interests of the fund and its management company. One of the larger funds, however, did foresee a potential conflict of interest and had developed a policy concerning outside directorships which recognized that a designated group within the fund complex made investment decisions and forbade anyone in that group from holding an outside directorship. Others, however, were encouraged to accept appointments because it provided access to the people in a company with operating information, though not necessarily inside information.

Whether current developments in Canada and the United States will result in development by the funds of a more rigid policy concerning outside directorships is still unclear. In October 1968, a leading Philadelphia banking house, Butcher & Sherrerd, resigned the 36 directorships it held in publicly owned companies. W. W. Keen Butcher, the firm's managing partner, said that this policy had been established because of a series of events in the business world which had tended to change attitudes concerning the role of investment bankers and stock brokers who serve on the boards of publicly owned companies. Although the presence of an investment banker on a board of directors results in important benefits to the company and all its stockholders, Butcher & Sherrerd relinquished all of its directorships in order to eliminate any possible conflict of interests.[156]

[156] The Globe & Mail, Oct. 2, 1968, § B, at 2, col. 3: "The managements of most corporations and securities firms have been re-examining their policies ever since the Texas Gulf and Merrill Lynch cases became prominent. The action taken . . . is believed to be the most drastic taken in response."

The Canadian funds, as well as other institutional investors, presently are faced with a conflict of interest problem that must be considered. On September 30, 1968, the Toronto Stock Exchange amended its *Corporate Guide To The Timely Disclosure Policy*. The thrust of this policy is to compel disclosure by listed companies of facts which can reasonably be expected to affect materially the value of the listed securities. The Toronto Stock Exchange has stated:

> When there is a situation where information is required to be kept confidential for corporate reasons management should watch closely the market activity in its securities. Unusual market activity in terms of price or volume is the best indication of whether confidentiality has not been maintained. If such activity occurs the Exchange requires that an announcement be made clarifying the situation.[157]

The fund with a director on a portfolio board might be placed in an awkward position if, through independent observation, it became aware of impending change and yet felt constricted in its freedom to trade in the portfolio company's securities. If the fund were to trade in the company's securities, the volume of trading might affect materially the issue price, and under its policy statement the Toronto Stock Exchange might temporarily suspend trading in the issue.[158] The fund or other institutional investor at a minimum should be careful in the information it elicits from its officers sitting as directors of portfolio companies.[159]

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157 TORONTO STOCK EXCHANGE, CORPORATE GUIDE TO THE TIMELY DISCLOSURE POLICY, Sept. 30, 1968, at 2.

158 *Id.* at 3.

> On some occasions unusual market activity is caused by the existence of rumors .... [A] clarifying statement is expected when the market activity indicates trading is being influenced by rumor. The most effective . . . is a prompt clarification or denial by a corporate release.
>
> The Exchange may *halt* or *suspend* trading in the shares of a company. Trading is halted pending the making of a corporate announcement and to allow for the dissemination of that announcement. . . . [W]hen . . . the market activity discloses that important news is available to some traders but not to the public at large .... [T]he public should have the opportunity to base their investment decisions to buy or sell listed shares on the best information available.

159 Using substantially the same criteria as the Ontario Securities Commission, the TSE seeks disclosure and reporting by insiders. 1 CCH CAN. SEC. L. REP. ¶ 3630. Included in the definition of insiders are any director of the company; any senior officer (president, vice-president, treasurer, secretary); and any beneficial owner of 10 percent of the outstanding *voting* securities of the company. (Aside from tax considerations, this proviso might help to explain the 10 percent limitation on voting securities imposed by the CMFA.)

The Commission's function under the Ontario Securities Act, 1966, c. 142, ONT. STAT.,

SUMMARY AND CONCLUSIONS

The fund behavioral pattern is directed toward investment protection and not the substitution of fund management for that of the portfolio company. Funds respond as investors, not controllers; they respond in terms of their own management capacity. Fund shareholders derive the distinct benefit of a unified fund management not fragmented by conflicts of interest. The shareholders of the portfolio corporation derive the benefit of a sophisticated check on management by the funds. In the thinking of the SEC both in 1940 and in 1966, there was a public policy use for the power of investment companies.[160]

Investment companies may serve the useful role of representatives of the great number of inarticulate and ineffective individual investors in industrial corporations in which investment companies are also interested. Throughout the course of the existence of such industrial corporations, various problems are presented to their stockholders which require a degree of knowledge of financial and management practices not possessed by the average stockholder. Investment companies by virtue of their research facilities and specialized personnel are not only in a position to adequately appraise these situations but also have the financial means to make their support or opposition effective. These investment companies can perform the function of sophisticated investors, disassociated from the management of their portfolio companies. They can appraise the activities of the management critically and expertly, and in that manner not only serve their own interests but the interests of the other public stockholders.[161] Direct efforts have been made in Canada to maintain the distinction between investment and control and, in light of demonstrated fund behavior, the fund industry understands and accepts this distinction. To some extent, the earlier discussed regulations of the Canadian Mutual Funds Association focus upon it. On

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as amended, c. 123 (1968) in part is to define more clearly insiders and their responsibilities under the Act by means of regulations. Under the terms of the Act not only may the Commission act to command reports, but, just as important, those reports are given to the public. *Id.* § 110(1); *see* 2 CCH CAN. SEC. L. REP. ¶¶ 51-160 at 9833. Finally, there rests with the corporation and any person a right of action against an insider who violates the disclosure requirements in connection with a capital securities transaction of the corporation that, "if generally known, might reasonably be expected to affect materially the value of such securities." The liability is to compensate for direct loss flowing from the transaction; moreover, the corporation may recover through accounting any *benefit* the insider received. (This assumes the information was not generally available.) Ontario Securities Act, 1966, ONT. STAT., c. 123, § 113 (1968); *see* 2 CCH CAN. SEC. L. REP. ¶ 51-168, at 9834.

160 *See* H.R. REP. No. 2337, 89th Cong., 2d Sess. 310 (1966).

161 *Id.*

their face, the regulations established by the fund industry itself impose limitations on the amount of voting stock of an issuer that may be acquired.

The lines drawn by the Canadian Mutual Funds Association have a certain clarity to commend them. Percentages of assets and issues can be measured with reasonable precision and without undue difficulty. The industry need not waste inordinate time in policing a law of absolutes; moreover, the percentages bespeak a policy that can be comprehended, although effective control of a large, publicly held corporation in fact can be gained with 10 percent of the voting stock.

Even though the funds do not want control over portfolio companies, their extraordinary growth coupled with investment in a decreasing number of issues can only increase their power to influence portfolio management. Funds have not been passive shareholders. They understand and use the power of their position, but this power has been directed not toward control so much as toward the protection of an investment. Despite their locked-in position in many selected issues, funds are market-oriented; they do not view their role as producers of goods. The power that the fund exerts must be viewed in the context of the market; it influences portfolio management not through the vote but through the threat of partial or total liquidation of an investment and the withdrawal of confidence which could destroy the prospect of any new equity issue or even private placement of bonds.

Laws should be passed which do not restrict funds in exercising sound business judgment as to the kind and quality of investment which will yield the best return. Nevertheless, it is a proper function of the law to allow the fund shareholder to know what he is buying and to insure that the fund conforms to a stated investment policy. The regulations of the Canadian Mutual Funds Association provide an adequate starting point for constructive proposals. The regulations reject the ambiguous, ill-defined concept of *diversified-fund* which is used in the United States. Rather, the Canadian Mutual Funds Association seems to say that for an entity to be a fund no more than a certain percentage of assets may be invested in a certain percentage of voting securities; it is not how a fund is labelled, but what it does with its monies that is significant. Furthermore, the regulations imply that no fund should be in a controlling position.

The Canadian Mutual Funds Association Regulations are restrictive. They deny existence to a fund that invests to control. In Canada, where efforts are being made to create and nurture new industry, there might well be speculative funds designed to finance and to start junior companies; there is no reason why funds should have to hold out the promise of safety and security to the investor who wants speculation. Most mutual funds presently do not have the kind of management to assume operative control of portfolio companies. Should the way be opened to such control, however, the requisite management might develop.

The necessity of a fund's honoring its pledge of redemption is not inconsistent with the development of a fund along the lines just described so long as existing law and the reality of fund practice is recognized. Most funds maintain positions of liquidity with a significant portion of their assets and in addition have the legal right to tender securities in lieu of cash.

A fund enjoys a special relationship with its shareholders. It seeks and obtains their money by offering an investment policy and the talent to implement that policy. It is not a relation of trust in the sense of conservation of assets or of secure investment, and the law should play only a marginal role in control over business judgment. An individual should have the right to invest in speculative ventures and to assume the corresponding loss if the venture fails. The role of the law is to assure a full and fair statement of the investment policy. It can isolate some of the elements vital to such a policy, such as whether the fund will consider taking control positions in selected issues, and, if so, whether the fund is equipped to manage control. If a fund places no limits on its size, it could be required to state how diversification and mobility will be achieved, and if control is not desired, how it will be avoided. These are not difficult objectives to fulfill, but their acceptance does force a fund to make a decision as to investment policy and, once made, to adhere to that decision.

The likelihood of a fund actively seeking control is remote. Not only do most mutual funds abstain from that objective, but they think it inappropriate in terms of the industry. A bank-related fund emphasized that the objective of the fund is to achieve a maximum return on its investment, and that to become too heavily invested in any one company increases the risk without necessarily increasing the return.[162]

The Canadian Committee endorsed this limitation on fund behavior and added that serious harm could result if a mutual fund were to assume control over a public company due to the disruption of the normal routine of the company, and the possibility of liquidation as a result of changed investment policy, perhaps dictated by factors completely unrelated to the company concerned. What the Committee sought from

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[162] MUTUAL FUND COMMITTEE REPORT, *supra* note 1, at 437.

the fund industry was an ongoing exercise in undefined good corporate citizenship.[163] Yet, to achieve the desired separation between control and investment, the Committee used percentage limitations and was expansive in its allowance. Conventional funds could use 10 percent, and nonconventional funds 15 percent, of their assets to acquire no more than 20 percent of any outstanding issue which could include a maximum of 10 percent of the voting stock;[164] however, more voting stock could be acquired if the relevant securities administrator believed the purchase was for investment and not control.[165]

The Committee recommendations perpetuate the existing system. By implication, the government study leaves it largely to the industry to fashion the distinction between investment and control. The difficulties with the Committee suggestions probably will be accentuated in the future as the market becomes more institutionalized and large funds grow to even greater size with greater investments. In this context, instances may arise when control is necessary to protect an investment, but a contemplation of the fund industry in this context is beyond the scope of the Committee Report.

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[163] *See id.*

[164] *Id.* at 439-42. In this regard the count would be based on mutual funds subject to the same management company. Thus, if Funds *A, B, C, D,* and *E,* though individually incorporated, were each under common management, and held 2 percent each of Company Z's voting stock, the maximum of 10 percent would be achieved.

[165] *Id.* at 441.

APPENDIX

TABLE 1

United Accumulative Fund Ltd.
Limitations on Portfolio Holdings
as of December 31, 1967

Name of Portfolio Company	Securities Held: Class	Securities Held: Amount	Market Value of securities held	% in relation to Funds total assets	% in relation to o/s of Portfolio Company
Western Broadcasting Co. Ltd.	Common	$ 85,000	$1,530,000	0.4%	9.7%
Magna Electronics	Common	30,000	547,500	0.1	8.6
Oshawa Wholesale Ltd.	Class A	520,000	16,120,000	4.2	10.2
Oshawa Wholesale Ltd.	Convertible Debentures 5½%, 1986	1,000,000	2,220,000	0.6	12.5
Canadian British	Class A	100,000	1,637,500	0.4	9.2
Aluminum Ltd.	Common				
Harding Carpets Ltd.	Class A Common	108,000	1,255,500	0.3	10.3
International Business Machines	Common	50,000	31,350,000	8.3	Negligible
Markborough Properties Ltd.	Common	250,000	1,718,750	0.5	6.9
	Warrants to purchase common shares	62,500	212,500	0.1	20.8
Wardair Canada Ltd.	6½% Series "A" Convertible Debentures due Sept. 15, 1982	400,000	500,000	0.1	13.3
Elcor Chemical Corp.	5½% Convertible Debentures due Nov. 1, 1987	1,500,000	1,432,500	0.4	12.0

Source: Canadian Committee on Mutual Funds and Investment Contracts.

TABLE 2

Investors Mutual of Canada Ltd.
Limitations on Portfolio Holdings
as of December 31, 1967

Anglo-American Corporation of Canada	Common	$ 546,239	$5,462,390	0.9%	6.5%
Calgary Power	Common	332,800	7,779,200	1.3	6.3
Investors International Mutual Fund Ltd.	Special	548,188	4,275,869	0.7	8.7
Steinbergs	Class A	280,700	4,771,900	0.8	7.6

TABLE 3

Investors Growth Fund of Canada Ltd.
Limitations on Portfolio Holdings
as of December 31, 1967

Indal Canada	Common	$ 52,500	$ 288,750	0.1%	8.9%
F.P.E. Pioneer Electric	Class A	71,910	2,013,480	0.9	31.0
M. Loeb. Ltd.	Common	140,000	1,785,000	0.8	5.4
Markborough Properties	Common	330,000	2,268,750	1.0	9.1
Maclean-Hunter Publishing	Common	32,000	2,112,000	0.9	6.4