18-year check up: Continuous disclosure review and guidance for IRCs

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Consistent with the securities regulators' focus on conflict-of-interest matters, staff from the Ontario Securities Commission (OSC) and the Autorité des marchés financiers (AMF) (Staff) have published guidance on Independent Review Committees (IRCs) for the first time in nearly 20 years.

After completing a continuous disclosure review of 24 investment fund managers (IFMs) of various sizes that are principally regulated by the OSC or the AMF, Staff published their findings and guidance in CSA Multilateral Staff Notice 81-337 *Targeted Continuous Disclosure Review and Guidance for Independent Review Committees for Investment Funds* (the Notice).

While the Notice does not propose any amendments to National Instrument 81-107 – *Independent Review Committee* (81-107), this BLG client alert outlines our views on the Notice, and steps that IRCs and IFMs may wish to take in response. The Notice and our commentary will be of interest to IFMs that are required to have IRCs for their reporting issuer funds, as well as to IFMs that have chosen to implement an IRC for their pooled or private funds for the purpose of relying on statutory and discretionary exemptions or that have constituted IRCs as a best practice.

IRC role and rationale

The Notice reminds readers of the origins and purpose of mandating IRCs for investment funds that are reporting issuers. The CSA introduced 81-107 in 2006 as a check on an IFM's activities when the interests of the IFM could diverge from the interest of investors in the fund.

IRCs are tasked with assessing two types of conflicts:

i. "business" or "operational" conflicts that arise in relation to the operation of the IFM; and
ii. "structural" conflicts that result from proposed transactions by the IFM with related entities, funds or portfolio managers.

The IRC's role is to review all decisions involving actual or perceived conflicts of interest brought to them by the IFM. Structural conflicts must be approved by the IRC before the transaction giving rise to the conflict may proceed, whereas other conflicts are only subject to IRC recommendation and can proceed even if the recommendation is negative.

The IRC's review of an IFM's approach to mitigating conflict of interest matters is intended to enhance investor protection with respect to both structural and operational conflicts. In today's context of enhanced regulatory scrutiny of conflict-of-interest issues, the Notice should spur IFMs to review their conflict of interest analysis and related policies, and revise them as necessary to reflect current industry standards.

Scope of authority

At least one of Staff's objectives in issuing the Notice is to reconfirm the relationship between IRCs and IFMs. The Notice is a reminder that the IRC plays a *supporting* role for the IFM by reviewing its handling of conflicts of interests; the IRC is not intended to replace the IFM's management of its funds.

There may be instances of disagreement between the IFM and the IRC as to what constitutes a conflict of interest to be brought to the IRC. Staff reiterates that under 81-107, responsibility for identifying and mitigating conflicts of interests of the investment fund rests with the IFM and not the IRC.

Once a conflict is identified by the IFM and brought to the IRC, IRCs have the authority to request additional information they determine useful or necessary from the IFM to carry out the IRC's duties. As well, the IRC may receive advice from independent counsel or other advisors it deems necessary.

An interesting comment in the Notice reminds IRCs that, while they have the ability to discuss any matter with the regulators, including where the IRC believes that a breach of securities law has occurred, Staff nonetheless ask IRCs not to reach out to the regulators for "inconsequential" matters. In general, we expect that IRCs will bring any issues of concern to the IFM to be addressed, prior to reaching out to the regulator for guidance.

IRC term limits

Despite speculation that the CSA would impose term limits for IRCs, Staff instead stressed the principle of ongoing turnover in IRC membership to maintain independence from the IFM. The takeaway is that IRC terms beyond six years should be the exception, not the rule. We expect IFMs will need to have difficult conversations with IRC members who have exceeded the six-year term limit, to explain why they may no longer be perceived as independent from the IFM.

With respect to the IRC Chair, Staff encourages setting a term limit to encourage turnover of leadership, and so as not to call into question the Chair's independence.

Skills, competencies and recruitment

81-107 recommends that IRC members possess a variety of skills and competencies. Staff encourage IRCs to be composed of members of varying skill sets to enable the committee to draw on diverse perspectives to inform their review of conflicts of interest. Staff also remind IFMs of the necessity for IRC orientation and education to enhance skills and competencies required for an effective IRC.

While the Notice encourages IRCs to lead the recruitment process to replace vacancies and not be overly reliant on the IFM's candidate suggestions, it is important to remember that 81-107 specifically states that the IRC must consider the manager's recommendations, if any, when filling a vacancy.

Size and diversity

81-107 stipulates a three-person minimum requirement for the composition of an IRC, allowing IFMs to determine the appropriate number of IRC members given the size of the fund complex and the scope of the conflicts impacting the funds. During their review, Staff confirmed that the three-person minimum provides for high satisfaction amongst IRCs and is conducive to IRC efficacy, diversity of thought, insight, and issue resolution.

IRCs are not subject to regulatory disclosure requirements regarding their diversity, nor are they required to mandate diversity policies. Without setting any quotas, Staff highlight that IRCs should pursue diversity beyond skillset and that diversity in IRC members can provide for wider perspectives informing their decision-making on conflicts of interest matters. As such, IRC membership that reflects all forms of diversity and, in particular those traits that are relevant to the fund and its securityholders, are encouraged by Staff. We have already seen some IRCs adopting diversity approaches similar to corporate board diversity policies. It will be interesting to see where the CSA land in terms of their proposed corporate board diversity approaches and whether those expectations impact IRC composition.

Compensation

The Notice contains enhanced guidance and expectations for IRC compensation disclosure. We expect many IRCs will want to review their compensation setting process and related disclosure.

Staff's review found a variety of IRC compensation levels. Unsurprisingly, larger funds pay their IRCs more than funds with fewer assets under management. IFMs set the initial compensation of the IRC pursuant to 81-107 and the Notice stresses that this compensation should be measured and justified based on the complexity and involvement of the IRC. IFMs should be transparent as to how IRC compensation was determined. Thereafter, IRC member compensation is determined by the IRC itself.

In their review, Staff found instances where the basis on which IRC compensation was allocated across funds was not specified in the IRC Report to Securityholders. Although it is not mandated, Staff encourage disclosure of how IRC costs are allocated among funds, on the basis that it is beneficial to investors. Boilerplate language to the effect that IRC fees and expenses are allocated across the funds in an equitable manner is insufficient.

Staff also noted discrepancies between aggregate IRC compensation amounts disclosed in the IRC Report to Securityholders and the amounts disclosed in the annual information form or prospectus of the fund. IFMs explained that these differences resulted from typographical errors, or the application of taxes, or the fact that some expenses are required to be disclosed in one disclosure document and not the other.

Staff note there should be a breakdown of individual IRC member costs in the fund's prospectus and that appropriate consistency in IRC compensation disclosure should be maintained between the prospectus and the IRC Report to Securityholders. Staff also encourage the disclosure of costs in Canadian dollars to enable appropriate compensation comparisons across IRCs.

Scope of responsibilities

IFMs are responsible for identifying conflicts of interest, as well as composing and evidencing a plan of action based on their written policies and procedures to mitigate such conflicts. IFMs are required to refer such conflicts to their IRC for their approval or recommendation, as applicable. IFMs are encouraged to take a broad and wide-ranging view of operational conflicts of interest on an ongoing basis. Additionally, IFMs should have a disciplined, established, organizational approach to identifying new operational conflicts of interest which may not have been previously considered. Such an approach may take the form of quarterly or other regular organizational meetings aimed specifically at identifying new conflicts.

In addition to assessing conflicts of interest matters, the IRC may also be tasked with additional functions, as agreed to with the IFM. Staff found that none of the IFMs reviewed had expanded the IRC's functions beyond conflicts of interest, due to the complexity, wide scope and implications of such matters.

Disclosure of IRC impact

Staff encourage a fulsome, substantive, and informative IRC Report to Securityholders, that provides a clear picture of the scope of the IRC's activities and its impact with respect to the mitigation of conflicts. As an example, enhanced procedures adopted by the IFM as a result of the IRC's approval or recommendation could be included in the IRC Report to Securityholders to showcase the impact of the IRC's work. We expect additional time will be required to draft the next IRC Report to Securityholders, to consider Staff comments.

Next steps

We expect IFMs and IRCs will want to use the Notice as an opportunity to assess their current practices.

Considerations for IRCs

- Set aside time at an upcoming IRC meeting for a general review of the Notice and to identify any changes required.

- Review the composition of the IRC and how new members are selected, to ensure an appropriate diversity in IRC membership.
- Review the length of service of all IRC members and consider succession planning and whether it is appropriate to adopt maximum term limits.
- Consider if/when to seek additional information from the IFM and/or support from qualified advisors.
- Review IRC compensation against market practice in the Notice and confirm it aligns with the size of the fund complex and complexity of conflict-of-interest matters presented to the IRC.
- Consider if current disclosure about IRC compensation and expenses in the IRC Report to Securityholders is sufficient, or if more description is required.
- Consider if any enhancements to the IRC Report to Securityholders are desired, to demonstrate the impact of the IRC's work.
- Consider whether IRC orientation and education from the IFM is sufficient, or if more support is required.

Considerations for IFMs

- Review the listed conflicts of interest in the Notice and consider whether there are any conflicts that may be applicable to your funds which have not yet been brought to your IRC. Document your thought process, particularly your rationale for why a conflict is not brought to the IRC for consideration.
- Consider your current approach to identifying conflicts of interest and determine whether your firm would benefit from training or a more disciplined approach to identifying conflicts.
- Review the composition of the IRC and how new members are recommended to the IRC, to ensure an appropriate diversity in the IRC's membership.
- Review the length of service of all IRC members and, if appropriate, initiate conversations about succession. Consider whether to recommend the adoption of maximum term limits.
- Revisit disclosure of IRC composition and compensation in the prospectus and IRC Report to Securityholders, to align with Staff expectations in the Notice.
- Consider whether you are providing the IRC with sufficient orientation and education, including education regarding the content of the Notice.

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