**ARTICLE FOR CETFA ON**

**CONFLICT OF INTERESTS AND IRCs**

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A brief history of Independent Review Committees (IRCs) is useful background to understanding the importance of IRCs as a pivotal governance tool. At the time of their proposed introduction, the industry advocated for a regulatory framework different from the US model. This became the fund governance model that we know today as National Instrument 81-107.

* In 1999, the CSA retained Stephen Erlichman to summarize the state of governance in Canada and abroad and to make specific recommendations to improve fund governance. He released his report entitled *Making it Mutual: Aligning the Interests of Investors and Managers: Recommendations for a Mutual Fund Governance Regime in Canada*.
* In March 2002, the CSA released Concept Proposal 81-402 *Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers (the Concept Proposal)* setting out their vision for regulating mutual funds and their managers. The Concept Proposal proposed a robust system of fund governance with a ‘board’-like body that would oversee all of the fund manager’s activities.
* On January 9, 2004, the CSA published for comment the first version of the Rule and Commentary (the “2004 Proposal”). In response to strong industry feedback to limit the role of the governance body, the 2004 Proposal narrowed the focus of the governance body, called the IRC, to oversee potential conflicts of interest that exist for investment fund managers in the operation of their funds.
* In May 2005, a [Notice of Request for Comments on Proposed National Instrument 81-107](https://www.osc.gov.on.ca/en/SecuritiesLaw_rule_20050527_81-107_not-ind-rev-com.jsp) was issued. After receiving comments, in November 2026, OSC Rule 81-802 Implementing National Instrument 81-107 Independent Review Committee was published with effect in 2007.
* Since 2007, IRCs have proven themselves to be an effective corporate governance model that has been embraced by the industry and the regulators. IRCs have been successful addressing conflicts of interest (“COI”).

Why does the work of an IRC matter to an investment advisor (“IA”) and their client?

The IRC framework was designed to consider and address COIs brought forward by managers. So, what is a COI? It is:

*“(a) a situation where a reasonable person would consider a manager, or an entity related to the manager, to have an interest that may conflict with the manager's ability to act in good faith and in the best interest of the investment fund”*

We consider a COI to be any circumstance where the interests of different parties, such as the interests of a client and those of a registrant, are inconsistent or divergent.

In a straightforward conflict of interest matter, the “*interest”* belongs to the Manager. Thus, the Manager is perceived to have a conflict between the courses of action that benefit it versus those courses of action that benefit the fund. This conflict may impair the Manager’s judgment. The *“interest*” referred to in NI 81-107 is not defined and would certainly include all pecuniary interest and other “interests’ as well.

Before a matter becomes a conflict of interest matter, two requirements have to be met; the situation has to give rise to an interest that may conflict with the manager’s ability to act i*) in good faith and ii) in the best interests of the fund*.

Once all tests are met, a COI exists. However, this is not meant to capture inconsequential matters. It is up to the manager to determine whether a conflict matter is inconsequential or not. The CSA has been clear that the obligation falls on the manager to determine whether to refer a matter to the IRC. Once the manager has determined that a conflict has arisen, the manager must refer the matter to the IRC “before taking any action”.

How do managers manage COI? and what is the IRC’s role?

It is the Manager’s responsibility to identify conflicts and to manage/monitor them, including to refer them to the IRC, where appropriate. The first key step is for a manager to create a Conflict of Interest Matters (COIM) Manual based on its internal policies and procedures that identify conflicts. The IRC will review and comment on the COIM.

The types of conflicts often include matters involving fees and expenses charged to the funds; trade allocations; dealing with pricing or other errors, best execution issues; soft dollar arrangements, short term trading and late trading and selection and monitoring of sub-advisors.

IRCs have no pro-active duty or role in the identification of conflicts. Its role and responsibility are to gain an understanding of the manager’s business well enough to ask probing questions. At each meeting and at the annual self-assessment process, the IRC will ask whether all COI matters have been referred to them and if not, inquire what the manager has done to address them.

If a conflict is referred, what must a manager provide to the IRC?

Implicit in every COI referred by a manager is the requirement that the matter be fully defined in a clear and unambiguous way. The onus is on the manager to define a COI and to bring it forward with its proposed course of action.

The referral memorandum must begin by describing the proposed course of action based on the manager’s written policies and procedures, how that course of action might benefit the manager and how it affects the funds. A timeline for those benefits to become evident will also be vital. In practical terms, these referrals might involve fund mergers or a change of external portfolio managers in addition to the type of referrals already mentioned.

How is a referral handled by the IRC?

We have discussed the Manager’s obligations to define the COI clearly and unambiguously and to provide complete information to the IRC. Although IRCs are expected to be re-active to the referral, once the matter has been referred, the IRC has authority to be pro-active in its review.

The foundational question for an IRC is whether the manager has provided sufficient background information and evidence. If not, the IRC may ask for more information about the COI, such as the details of any legal and other advice received by the manager and the deciding factors leading to the proposed course of action as well as any alternative courses of action considered but rejected. This should include a description of how the manager’s proposed action will mitigate the conflict. Most importantly, the manager should also discuss the impact on the security/unit holders of the Fund(s) of the proposed course of action.

## The CSA expects the IRC “to bring a high degree of rigour and skeptical objectivity to its review of conflict-of-interest matters, but not to second-guess the investment or business decisions of a manager, or an entity related to the manager.”

Types of review: recommendation versus approval

Essentially, the obligation of the IRC is to ensure that the manager follows its policies and procedures. As a matter of securities law, some matters require IRC approval while lesser matters only require a recommendation. In either circumstance, the reporting of those referrals in an annual report is noteworthy and may lead a reader to ask further questions.

The manager’s most important obligation is to meet its fiduciary duty to the funds. Accordingly, when the manager puts forward a proposed course of action, the IRC must be satisfied that it meets the manager’s fiduciary duty. It is not enough that the proposed action be simply legal. The IRC must then consider whether all aspects of the proposed course of action produce a fair and reasonable result. A security/unit holder can take comfort from the fact that given the importance of referrals, its IRC will be deliberate and not be pressured into making a quick decision.

The investment advisor and their client’s review of the annual report should extend to whether the IRC imposed any conditions on its recommendation or approval. Those conditions will make clear whether the IRC required more frequent reporting from management including potentially requiring the delivery of a certificate from senior officer(s) about adherence to the conditions and the achievement of benefits for the security/unit holders.

Recent regulatory guidance in August 2023 and March 2024

Investment advisors and their clients should look to the regulatory pronouncements made from time to time by the CSA, given the vital nature of that guidance. Two recent Notices providing Staff Guidance are relevant here. In 2023, the provincial regulatory authorities did a sweep of IFMs within their jurisdictions, resulting in Staff Guidance being published in August 2023. Its findings noted a number of deficiencies. The deficiencies included: failures to identify material COIs; inadequate controls to address those COIs in the best interest of the client; instances of missing and/or incomplete disclosure; inadequate policies on COIs as well as a lack of training to identify them; and inadequate record-keeping. The Staff Guidance also highlighted specific examples of COI. These recommendations were useful to managers as well as to their IRCs. The industry is working diligently to address them.

In March 2024, the CSA published guidance addressing a number of issues relevant to IRCs including the following areas:

* IRC Term Limits – that the IRC terms should be a maximum of six years unless exceptional circumstances are present;
* Expanded Scope of IRC Review – that the highest onus is on the IFM to identify, bring forward and mitigate COI and that the role of the IRC is to be re-active,
* Skills, Competencies and Recruitment – that certain specific skills for IRC members should include: knowledge of the financial, securities and investment fund industry; inter-personal and strong communication skills; leadership management and industry experience; an ability to align with the investor’s perspective while providing different thoughts or perspectives; and, time and interest in serving on the IRC; and,
* Diversity – that DEI principles ought to be set out in the constating documents for the IRC.

While our article does not permit us to go into detail about the 2024 Staff Guidance, the regulatory pronouncements were well received as they responded to many outstanding questions and helped to further delineate the IRC’s jurisdiction and responsibilities.

What does the future hold for IRCs?

IAs and their clients should scrutinize a fund’s annual report to security/unit holders to determine what occurred in any particular year. The reader should pay specific attention to any referrals and how they are resolved.

While we acknowledge that IRCs have a limited statutory mandate and do not operate with the authority and responsibility of a board of directors, the lessons from the latter world will undoubtedly spill over onto the NI 81-107 world. Indeed, it seems obvious that a manager should put in place a best-in-class corporate governance regime to manage COI.

Managers will continuously develop policies and programs to meet the evolving regulatory regime. In turn, their IRCs will adapt and need to ask questions about a manager’s business so that there is confidence that COIs are being surfaced. IRCs and managers will continue to engage in an active dialogue updating information about the manager’s business and about its funds. This exchange of information will ensure that the IRC’s review and oversight is effective.

While IRCs will continue to function alongside the manager’s board of directors, its work and responsibilities remain pivotal to good fund governance. We may even see its role expanded over time given the public’s expectation of greater oversight by this important independent body.