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* Pension Plan Auditing (1984)
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*Research Study
Notice to Reader
The Knowledge Development Group of the Canadian Institute of Chartered Accountants (CICA) commissioned this Research Report as part of its continuing research program. The views and conclusions expressed in this publication are those of the Study Group. They have not been adopted, endorsed, approved, disapproved or otherwise acted upon by a Board, Committee, the governing body or membership of the CICA or any provincial Institute/Ordre.

The CICA Research Report Asssessing Risks & Controls of Investment Funds is available on the Internet (www.cica.ca).
In 2000, the Canadian Institute of Chartered Accountants (CICA) published the Research Report Assessing Risks & Controls of Investment Funds: Guidance for Directors, Auditors and Regulators. In 2007, after consulting with the industry, auditors and regulators, the CICA decided to update that Research Report to reflect new regulatory requirements and significant events occurring in the investment funds industry.

A Study Group was set up to provide new or revised guidance regarding matters such as:
• Recent changes in governance requirements and practices including National Instrument 81-107, Independent Review Committee for Investment Funds;
• New and proposed rules and policies of the regulators including the protection of personal information (privacy), anti-money laundering and anti-terrorist financing;
• Issues that have arisen in the investment funds industry in Canada and the United States in recent years including late trading, market timing, high closing, valuation issues and frauds;
• Changes in auditing and assurance standards including audit guidance on fraud, audit risk, controls at service organizations and transition of CICA Handbook-Assurance from Canadian generally accepted auditing standards to International Auditing and Assurance Standards;
• Evolution of risks and controls as they relate to investment funds.

The issues covered in this updated Research Report are considered in the context of a risk management process and an integrated risk and control framework that can be applied to all types of investment funds with a particular focus on open-ended mutual funds. Additional consideration would be required for alternatives such as REITs (Real Estate Investment Trusts), hedge funds and commodity funds which have not been addressed in this Report.

The Study Group believes that it is important to understand the business, audit and compliance perspectives. In addition, an understanding of the different perspectives of boards of directors, audit committees, independent review committees, senior management, internal auditors, regulators and even investors themselves is highly desirable, if not essential. It is anticipated, therefore, that this Research Report will provide a useful reference source for all parties associated with investment funds.

The CICA expresses its appreciation to Raj Kothari, FCA, and the members of the Study Group listed on the next page for the significant time and effort they put into completing this project. Equally appreciated is the work of Donald E. Jeffreys, CA, consultant and researcher, who assisted in drafting the report, and Paul-Émile Roy, CA, who directed the project.

The CICA also acknowledges the contribution by Melissa Kelman, BMO Financial Group; Alan Hann, Edward Lee, CA, and Rebecca Wong, CA, of Ernst & Young LLP; Benita Warmbold, CA, Northwater Capital Management Inc.; James Cooper, CA, Derek Hatoum, CA, Ryan Leopold, CA, Arturo Lopez, CA, Nadia Rafael and Stephen Wall, CA, of PricewaterhouseCoopers, LLP; William Tabin, Royal Bank of Canada; and those who assisted the Study Group by providing comments on an associates’ draft of the Report.
The views expressed in this publication are those of the Study Group and have not been formally endorsed by the CICA. Comments are welcome and should be addressed to J. Paul-Émile Roy, CA, Principal, Research Studies Department, CICA (research.studies@cica.ca).

Toronto, March 2009 CICA Research Studies
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According to statistics prepared by the Investment Funds Institute of Canada (IFIC), there were more than 52 million investment fund investor accounts in 2007 and total assets under management in Canada reached $700 billion. To adequately oversee such enormous accumulations of public money, boards of directors, audit committees, senior management, fund managers, auditors and regulators must have a comprehensive understanding of investment fund risk management. This Research Report provides an extensive reference source on the topic. It deals primarily with risk and control issues that are likely to be encountered by conventional mutual funds. Nevertheless, it is anticipated that the guidance will also be applicable to all types of investment funds, as well as to segregated funds.

The Report examines current thinking from the perspectives of business, compliance and audit. It concludes that effective risk management requires an integrated approach and accountability to investors. In the current, ever-changing business environment, an investment fund must not only satisfy the demands of its stakeholders, but must also strive to exceed the performance of its competitors. That means a fund’s risk profile must be continually reviewed to ensure that existing risks are maintained within tolerable levels, and that new risks are identified as soon as they appear.

As Exhibit 1 illustrates, risk management is a continuous, evolving process that is relevant to all facets of the investment management business. That process encompasses a fund’s mission, objectives, risks and controls. The “mission” of a typical investment fund is to enhance investor value (that is, maximize performance returns within the fund’s mandate and within acceptable risk). To achieve its mission, the fund establishes specific objectives. Risk identification and assessment provide a basis for understanding the risks that may prevent those objectives from being met. Control identification and assessment provide the means for mitigating risks, thereby allowing for the achievement of the fund’s objectives and mission.

Exhibit 1

In applying the risk management process, an investment fund may establish a number of objectives, for example: to maximize investment returns in relation to the investment objectives and policies; to safeguard investors’ interests within the fund’s prescribed mandate; to provide a level of service, including reporting, that meets investors’ needs; to ensure operating procedures and controls are established to effectively manage risk; to minimize the fund’s expenses while maintaining an acceptable standard of service; to ensure safekeeping of the fund’s assets; to operate the fund within the context of all relevant legal requirements; and to protect the fund’s reputation and the fund manager’s reputation. Where a high level of risk exists, a specific objective or a set of sub-objectives may have to be established as well.
A particular risk can have many dimensions. It can interact with and be interrelated with other risks. Different risks can arise from the same source. They can result in the same or different consequences. Therefore, it is crucial for a fund’s governing body, in conjunction with senior management, to identify the risks of not meeting the fund’s objectives and to specify the control measures that should then be put in place to prevent unacceptable risks, manage and monitor acceptable risks, and mitigate unexpected risks.

Exhibit 2 shows that investment fund risks and related control measures can be broadly categorized into an integrated framework that covers four areas: nature of business, governance, operations and compliance (details are set out in Appendix A of this Research Report). The framework provides a basis for identifying, measuring, managing, monitoring and reporting on risks and controls.

For each part of the framework, this Research Report offers a series of possible control measures that—individually or in combination—can be used to manage risk. Selecting appropriate control measures will depend, however, on the nature and extent of the particular risks facing the investment fund. In addition, this selection will require the exercise of professional judgment.

Exhibit 2
The following summarizes the Study Group’s views and conclusions, presented by chapter of this Research Report.

Chapter 1 – Introduction
Professional investment management of public money requires a comprehensive understanding of investment fund risks and management thereof with mitigating controls. In the Study Group’s view, effective risk management requires an integrated approach. Accountability may be viewed as “an obligation to answer for the discharge of responsibilities.” Operating in a cooperative and supportive environment, the key stakeholders — the governing body, management, regulators and auditors — are partners in the accountability chain to investors. The ultimate accountability to investors, however, rests with an investment fund’s governing body.

The Study Group believes that risk management is a continuous, evolving process that is relevant to all facets of a fund’s business. An investment fund’s risk management process encompasses a mission, objectives, risks and controls. The mission of a typical investment fund is to enhance investor value (that is, maximize performance returns within the fund’s mandate and within acceptable risk). To achieve its mission, a fund establishes specific objectives. Risk identification and assessment provides a basis for understanding the risks that may prevent those objectives from being met. Control identification and assessment provides the means for mitigating risks and, thereby, helps to achieve the objectives and the fund’s mission.

Risk is a factor or condition that would prevent the fund from meeting its objectives. It is also the possibility that one or more individuals or organizations will experience adverse consequences. A particular risk can have many dimensions. It can interact with and be interrelated with other risks. Different risks can arise from the same source. They can result in the same consequences. The Study Group believes, therefore, that it is crucial for a fund’s governing body, in conjunction with senior management, to identify the risks of not meeting the fund’s objectives and to specify the control measures that should be put in place to prevent unacceptable risks, manage and monitor acceptable risks and mitigate unexpected risks.

In light of an investment fund’s accountability to investors, the Study Group proposes a risk/control framework for investment funds. The four areas covered by the framework are: the nature of business (discussed in Chapter 2), governance (discussed in Chapter 3), operations (discussed in Chapters 4, 5 and 6), and compliance (discussed in Chapters 7 and 8). In the Study Group’s view, an effective risk/control framework should operate equally well in all circumstances—under normal market conditions, in periods of market disruption and during times of business interruption.

In the Study Group’s view, the proposed risk/control framework provides a sound basis for identifying, measuring, managing, monitoring and reporting on risks and controls. For each part of the framework, this Research Report offers possible control measures that—individually or in combination—can be used to manage risk. Selecting appropriate control measures will require professional judgment and will depend on the nature and extent of the particular risks facing each investment fund.
Chapter 2 - Nature of Business
Chapter 2 addresses investment fund risks associated with fund objectives and strategy, and the operating, regulatory and marketplace environments.

Strategic Management
According to the Study Group, the focus of strategic management should be on the critical success factors that impact the success or failure of an investment fund in achieving its objectives. From a fund manager’s perspective, success is gauged by the ability of the fund to attract and retain investors and to grow assets under management. It is important, therefore, to consider why investors would choose one fund over another. Often, the choice is based on a combination of performance (of the fund manager, the fund and the investment adviser), the ability of the fund manager and the fund to deliver on stated objectives, client service, product design and development, sales and marketing (including investment adviser and dealer compensation), the distribution channels used, expense ratios and management integrity. The Research Report examines each of these critical success factors and how they may relate to the investment fund, the fund manager, or both.

Operating Environment
In the Study Group’s view, assessing business risks inherent in an investment fund’s operating environment starts with a sound understanding of how a fund plans to meet its stated investment objectives. What governance structure has been established? What operating structure is in place, including risk management, human resources, various servicing agency relationships and the integrity of net asset value data? Is there an appropriate business continuity plan for both the fund manager and for the funds it manages?

Regulatory Environment
An investment fund’s regulatory environment covers both legal and compliance matters. The Study Group believes that, in light of the regulated nature of the investment fund industry and the impact that non-compliance with certain regulations could have on an investment fund, regulatory compliance should be carefully considered when addressing inherent risk. Because investment funds vary considerably, it is important that a fund’s business objective, tax consequences and regulatory regime be clearly understood by those responsible for the fund management and oversight.

Assessing the risks in an investment fund’s regulatory environment starts with a sound understanding of the fund’s legal structure and compliance requirements. This includes management’s attitude toward compliance, management’s experience with, or knowledge of, compliance issues, and whether there are systems in place to ensure compliance with regulations and to monitor legislation for changes.

Marketplace Environment
With regard to the marketplace environment for investment funds, the Study Group concludes that it is essential to consider the key elements of competition, complexity of fund structures, distribution strategies, operating risks and financial risks.

Chapter 3 - Investment Fund Governance
Chapter 3 examines how investment fund governance applies to both investment funds and their managers. It addresses investment fund governance risks associated with leadership, stewardship, responsibility and accountability.

Leadership
In the Study Group’s view, governance fulfils a leadership function. Leadership encompasses the legal and ethical relationships between the governing body and those governed. The key elements of leadership are the independence and effectiveness of the governing body.
The Study Group believes that governance is enhanced when investment fund managers follow fiduciary principles in managing investment funds. Suggested control measures for assessing independence are presented in Exhibit 3.1.

A governing body’s effectiveness depends on how well that governing body discharges its roles and responsibilities as part of the overall control environment and in light of its mandate. The Study Group believes that governance is enhanced when the assessment of effectiveness addresses the structure, duties and responsibilities of the fund manager, as well as its compliance culture and its compliance with regulation and fiduciary principles. Suggested control measures are presented in Exhibit 3.2.

**Stewardship**

Stewardship is about establishing appropriate goals, priorities and relationships to safeguard and protect the interests of investors. As stewards, fund managers act for investors in managing the investment funds, and have responsibilities that are defined by fiduciary responsibilities, as well as compliance with legal requirements and ethics. They have responsibility for monitoring the management of the funds and are required to act solely in the best interests of the funds.

The key element of stewardship lies in the operations and actions of the fund manager. But, given the unique responsibilities of fund managers, stewardship for investment funds encompasses the manager’s responsibilities to meet its fiduciary responsibilities to the fund, including through its ethics program.

The Study Group believes that governance is enhanced when a fund manager assumes responsibility for the stewardship of the investment funds by:

- clearly defining the powers, duties and responsibilities of the fund manager through a written and functioning compliance regime; and
- monitoring, reviewing and approving the fund manager’s methods of managing conflicts of interest on a periodic basis.

Suggested control measures for assessing mandates are presented in Exhibit 3.3.

In addition, the Study Group maintains that governance is enhanced when a fund manager ensures that an effective ethics program is in place:

- to create and sustain an ethical culture that guides decision making;
- to demonstrate to investors, regulators and others that the fund manager’s ethics are soundly managed and that the fund manager is trustworthy;
- to educate management and employees about the fund manager’s principles and values and help them determine appropriate business practices and behaviour; and
- to demonstrate that the fund manager is acting in accordance with fiduciary principles.

Potential fraud risks are highlighted in Exhibit 3.4 and suggested control measures for assessing the ethics program are presented in Exhibit 3.5.

**Responsibility**

The key elements of responsibility are oversight of conflicts of interest and risk management. In the Study Group’s view, the fund manager of an investment fund has a responsibility to manage the funds efficiently and effectively, which includes ensuring that conflicts of interest are properly managed and that the process for managing conflicts of interest is properly documented in policies and procedures. Fund managers must act honestly and with good faith, and must possess appropriate competencies and skills. They are also expected to
devote the time and energy required to ensure that governance is appropriate and adequate. The Independent Review Committee (IRC) has a key role in overseeing the methods the fund manager adopts to mitigate its conflicts of interest.

The Study Group believes that governance is enhanced when the fund manager assesses regularly which conflicts of interest it has when managing investment funds, and how it manages those conflicts of interest. Fund managers must take into account IRC recommendations on conflicts of interest that they have referred to the IRC. The IRC evaluates, at least annually, the fund manager’s approach to managing conflicts of interest. Suggested control measures are presented in Exhibit 3.6.

Risk management is key to the activities of the fund manager in properly managing investment funds. In this regard, the Study Group believes that governance is enhanced when the fund manager assumes responsibility for:

- identifying the principal risks of its business and ensuring that appropriate systems are implemented to manage these risks;
- the integrity of internal control and management information systems; and
- the adequacy of the business continuity and contingency planning.

An IRC will have some responsibility over these matters to the extent they relate to its mandate: to consider conflicts of interest referred to it by the fund manager. Control measures for assessing risk management are presented in Exhibit 3.7.

**Accountability**

Accountability is the obligation to answer for the discharge of responsibilities that affect others in important ways. It requires that all parties understand who is responsible for what, what information needs to be shared among the parties involved to form the basis for dialogue and what performance is to be achieved. Key elements of accountability are oversight of the financial reporting process and communications.

Accountability will generally apply to the fund manager’s board of directors. The Study Group believes that governance is enhanced when the board of the fund manager (or one of its committees) takes responsibility for oversight of the financial reporting process, with specifically defined roles and responsibilities. As a minimum, the duties of an oversight body should include:

- review of the fund’s financial reporting activities;
- oversight responsibility for management reporting on internal control;
- direct communications with the internal and external auditors.

Suggested control measures for assessing the audit committee role are presented in Exhibit 3.8.

Communications deals with the responsibility of a governing body to communicate information to and from external parties, including investors. The Study Group believes that governance is enhanced when the fund manager assumes responsibility for a communications policy that encompasses approval of disclosures, external and internal communications and confidentiality. Suggested control measures are presented in Exhibit 3.9.

**Chapter 4 – Investment Fund Operations**

Chapter 4 examines investment fund operations regarding agency relationships and the valuation of investments. Agency relationships could encompass investment adviser, transfer agent and custodian (see Exhibit 4.1), as well as fund accounting and reporting (discussed in Chapter 5). Valuation of investments encompasses basic methods of valuation, securities valued using publicly-traded available quotations, securities valued using other
than publicly-traded available quotations, and special circumstances affecting the valuation of investments.

**Agency Relationships**

A fund’s significant operational activities may be performed by its fund manager or contracted out, or a combination of both. Exhibit 4.1 shows that the service organizations, functions or agents involved in carrying out the operations include:

- **Investment Adviser.** Investment advisers manage the investment portfolio, providing investment analysis and making decisions about how the fund’s assets are to be invested. An investment adviser may also choose to engage a sub-adviser to provide these services for some or all of an investment fund’s portfolio.
- **Transfer Agent.** The transfer agent maintains the records for investors, including transaction histories.
- **Custodian (including securities lending).** The custodian usually performs several functions, such as maintaining custody of a fund’s investments and, possibly, acting as a lending agent for those investments.
- **Fund Accounting and Reporting.** These functions are generally handled by a group known collectively as “fund accounting.” Fund accounting maintains a fund’s general ledger, prepares financial statements and other related reporting as well as calculates the fund’s daily NAV. Fund accounting and reporting is discussed in Chapter 5 of this Research Report, with the exception of valuation of portfolio investments which is discussed in this chapter.

Although an agency relationship may exist for any or all of these functions, ultimate responsibility for the fund remains with the fund manager. With regard to agency relationships, the Study Group identifies a number of factors or conditions that may influence the assessment of risks associated with the transfer agent, for example:

- dormant or nominee accounts may make the fund more susceptible to fraudulent activities or the manipulation of investor records;
- unreconciled trust accounts;
- poor communication among the fund manager, transfer agent, distributor and fund accounting agent;
- volume of non-financial updates to investor accounts;
- complexity and extensiveness of the distribution network for sales and redemptions;
- complexity of product and the unit structures associated with varied fees.

It also identifies the core objectives of the transfer agency, together with the corresponding risks of not meeting the objectives (see Exhibit 4.2). In the Study Group’s view, control measures over the processing of transactions are vital to ensure the accuracy of investor information. Although some controls are designed to ensure that funds comply with securities regulations, they also provide assurance on the accurate and timely processing of transactions. Control measures for assessing the appropriateness of transfer agency activities are presented in Exhibit 4.3.

**Valuation of Investments**

In the Study Group’s view, the portfolio values and changes in those values have a much greater impact on the fund’s performance than does the investment income earned. Historically, many funds have invested primarily in listed investments where valuation and accounting were readily determined. However, the types of products investment funds offer are continually expanding, investment strategies are becoming more sophisticated and the investment vehicles themselves are increasingly complex. These trends create an environment of higher valuation risk for either a specific fund or an entire group of funds. To address this higher risk, it is important to consider all events and circumstances that
may affect the valuation of investments. It is essential to understand what is done (practice), why it is done (policy), who is doing it (individuals), when it is done (timing), where it is done (external/in-house) and how it is done (techniques).

In this chapter, the Study Group highlights issues related to various types of investments. It examines the basic methods used for valuing various types of investments for purposes of determining the NAV per security. It also shows that, in certain circumstances, it may be appropriate or necessary to estimate the fair value of investments in good faith (see Exhibit 4.4).

In addition, the Study Group identifies the core objectives of the valuation of investments, together with corresponding risks of not meeting the objectives (see Exhibit 4.5). The primary objective in the valuation of investments is to consider all events and circumstances that may affect their underlying value so that the fund’s NAV can appropriately reflect the current value of the investment portfolio. The valuation of investments requires judgment, which may be based on viewing them on a spectrum—the more complex the investment, the more judgment is needed, the greater the risks and the greater the need for control measures. The more complex the investments, the greater the need for specially designed and specifically defined valuation processes. In the Study Group’s view, the primary focus of the fund manager and the auditor should be on areas of high risk. The valuation methodology used in risky areas should be triggered by specified criteria and should be assessed for appropriateness and effectiveness.

When assessing the risks associated with the accurate valuation of investments, the Study Group believes that it is important to consider the factors that can affect an investment fund’s ability to accurately value or account for its portfolio and portfolio transactions, including:

- the experience the fund accounting staff and investment advisers have with the investment vehicles;
- the complexity of the transactions;
- the liquidity or ability to sell the investment at the ascribed market value taking into account the available public market, the size of the block of investments, general market conditions and regulatory restrictions;
- the valuation source, including the ease of obtaining a market value from a publicly available source and assessing the competence and independence in the valuation of the expert, such as a broker;
- the processing and whether the transactions are cumbersome or complex to process, thus making them more prone to clerical errors;
- the regulatory requirements that may restrict the use of specific investments or the make up of the overall portfolio strategy;
- the tax implications of each investment and the complexity of the issues.

The Study Group suggests a number of control measures that may assist in managing such risks, including objectives and strategies, policies and procedures, daily fluctuation review, investment sub-ledger reconciliations and other valuation assessments (see Exhibit 4.6).

Chapter 5 – Investment Fund Operations

Chapter 5 deals with risks associated with an integral aspect of investment fund operations—fund accounting and reporting. This encompasses the net asset value (NAV) per unit, calculating the NAV, pricing errors, financial reporting, management report of fund performance (MRFP) and performance reporting.

Fund Accounting

With regard to fund accounting, the Study Group identified a number of factors and conditions that
may influence the assessment of risk inherent in fund accounting functions, including the following:

- nature of, and circumstances surrounding, contractual arrangements with service providers;
- complexity of share structures and fund-on-fund arrangements requiring judgments about allocations of income and expenses;
- dissatisfaction with performance of service providers;
- backlogs in processing or completing reconciliations;
- repeated errors in the computation of the NAV;
- cash management problems (for example, excess cash balances, unexpected overdrafts or untimely expense payments);
- inadequate cash availability reporting for daily investment purposes;
- significant fluctuations in expenses or ratio of expenses to net assets;
- staff turnover, staff training and regulatory changes.

It also identifies the core objectives of fund accounting, together with corresponding risks of not meeting the objectives (see Exhibit 5.1). In addition, the Study Group suggests a number of control measures that may assist in managing such risks, including management reviews and approvals, reconciliations and compliance with regulatory requirements (see Exhibit 5.2).

Chapter 6 – Investment Fund Operations (Continued)

Chapter 6 examines investment fund operations regarding information systems. Information systems encompass reliance on information technology, information systems related risks, and risk management. Many investment funds rely on information technology (IT) to support their day-to-day operations, including accounting and reporting. This is particularly true of funds having a large number of investors or investment holdings or a high volume of investors or investment transactions. Funds use IT to support the volume of transactions, enhance efficiency through automation, process transactions on a timely basis and interact with other market participants that transact through electronic means.

Information Systems

When it comes to information systems, technology often supports the operation and accounting for investment funds in the following areas:

- transfer agency functions;
- trust accounting;
- investment management and trading;
- asset custody; and
- fund accounting.

Therefore, the Study Group believes that understanding the nature and extent of IT involvement in fund operations is a critical component of understanding and evaluating the risks and controls over investment fund activities. In the Study Group’s view, IT poses significant risks for fund operations. Those charged with managing a fund should ensure that processes and controls are implemented to mitigate those risks. Furthermore, it is essential to determine the extent to which the investment fund’s service agents use IT systems for the processing of transactions and related data, the extent to which the fund’s operations depend on those systems, the nature of the risks associated with those systems and the control measures in place to mitigate such risks.

In the Research Report, the Study Group identifies risks and related controls associated with IT general controls (see Exhibits 6.1 and 6.2) and information processing objectives (see Exhibits 6.3). Typical control objectives and control measures are set out for each of the functions listed, as well as considerations related to end-user computing, the use of service providers and contingency planning.
Chapter 7 – Investment Fund Compliance

Chapter 7 addresses investment fund compliance risks associated with legal and regulatory requirements, industry practices and taxation. An investment fund’s principal objectives are to ensure that the compliance function is well defined, responsibility is delegated to an appropriate individual or group, and adequate resources are provided.

Legal and Regulatory, Industry Practices and Taxation

Failure to comply with the legal and regulatory requirements can have serious consequences. The potential impact on a fund violating legal and regulatory requirements will depend on the nature of the violation, the period over which the violation occurred and the resulting loss, if any. In some cases, a violation may result in reputational damage or in litigation between the investors and the investment adviser/fund manager. Violations of regulatory restrictions could trigger sanctions such as a cease trading order, which would prevent the fund from being subscribed to or redeemed from (bought or sold).

For these reasons, the Study Group maintains that management should establish policies and procedures to ensure that a fund complies with all legal and regulatory requirements throughout the year, including:

• training designated individuals to understand the legal and regulatory requirements so that they can adhere to them;
• training designated individuals to independently monitor compliance of operations staff;
• implementing systems and procedures to identify, isolate and inform management of violations on a timely basis; and
• developing specific action plans to deal with violations promptly and effectively.

Suggested control measures are presented in Exhibit 7.1 (legal and regulatory), 7.2 (industry practices) and 7.3 (taxation).

Chapter 8 – Investment Fund Compliance (Continued)

Chapter 8 considers assurance reports on the audit of financial statements, compliance with National Instrument 81-102, prospectuses and annual reports, and other assurance services.

Audit of Financial Statements

In considering the auditor’s report on investment fund financial statements, the Study Group reviewed Canadian generally accepted auditing standards and specifically considered the Recommendations in the following sections of the CICA Handbook – Assurance: “Audit of Financial Statements – an Introduction” (Section 5090); “The Auditor’s Standard Report” (Section 5400); “Date of the Auditor’s Report” (Section 5405); “Reservations in the Auditor’s Report” (Section 5510); and “Other Reporting Matters” (Section 5701). In the Study Group’s view, the Recommendations in these sections apply to the audit of investment funds.

Compliance with National Instrument 81-102

National Instrument 81-102 (Part 12) deals with compliance reports. In the Study Group’s view, the auditor’s report on mutual fund compliance, the auditor’s report on principal distributor compliance and the auditor’s report on participating dealer compliance should take the form set out in National Instrument 81-102 (Part 12).

Prospectuses and Annual Reports

In the Study Group’s view, the Recommendations in CICA Handbook – Assurance Sections 7110 “Auditor Involvement with Offering Documents of Public and Private Entities” and 7500 “Auditor Association with Annual Reports, Interim Reports and Other Public
Documents” also apply to investment fund financial reporting. The Study Group believes that investment fund managers and their auditors should recognize the need to prepare designated public documents so that they highlight significant information to investors and other interested parties while also fulfilling the requirements of regulatory authorities.

**Other Assurance Services**

With regard to the provision of assurance services to investment funds, the Study Group concludes that, in their capacity as independent providers of expert professional assurance and advisory services, public accountants are well positioned to assist investment funds in achieving their objectives. Working with a fund’s governing body and senior management, the accounting profession can provide, and currently is providing, assistance in identifying risks and control measures to facilitate the achievement of the fund’s mission. In this regard, many believe that providing assurance on information required for strategic decision making may be as important as the assurance provided by the audit of financial statements.
PURPOSE OF THIS REPORT
In 2000, the Canadian Institute of Chartered Accountants published Assessing Risks & Controls of Investment Funds—Guidance for Directors, Auditors and Regulators. The purpose of this report is to update that publication and provide an extensive reference source on investment fund risk management. Accordingly, this report examines current thinking from a business perspective, an audit perspective and a compliance perspective. It deals primarily with issues that are likely to be encountered by conventional mutual funds. Nevertheless, it is anticipated that the guidance will also be of interest to the various groups associated with all types of investment funds.

ABOUT INVESTMENT FUNDS
An investment fund is an entity that offers its units or shares for sale to investors, including institutions. Operating on a “pooled” basis on behalf of individual investors, investment funds give investors access to professional investment management services and diversified investments. Investment funds offer their units or shares for sale to the public, sometimes receiving special tax treatment. The investment funds industry is highly specialized and intensely competitive. Accordingly, it is subject to close public scrutiny and detailed government regulation.

Normally, a fund manager sponsors the investment fund, provides the initial seed capital and markets the fund to investors. The fund manager is responsible for the provision of all services to the fund (for example, record keeping, fund accounting, back-office order processing). As compensation, the fund manager receives a management fee, which is normally calculated as a specified percentage of the fund’s net assets. The fund’s investment adviser advises the fund manager and, consequently, the fund on the fund’s investment portfolio.

Open-end mutual funds, which are offered by prospectus, usually offer their units/shares for sale to the public continuously. Because their capitalization is generally not fixed or limited in any way, they are ready, in most circumstances, to redeem their units/shares at a price equal to the net asset value (NAV) of each unit/share.

Closed-end funds are generally listed on a recognized stock exchange and are referred to as exchange-traded funds. They have a fixed number of units/shares outstanding, which are generally non-redeemable. The units/shares are traded similarly to those of public corporations (on a stock exchange or over the counter) at a price that is either at a premium or a discount to the NAV per security.

Exchange-traded funds also include ishares and similar products which offer their shares to the public continuously. Their shares are redeemable on demand or at specified time periods (typically daily).

“Individual variable insurance contracts” (commonly called ”segregated funds”) are pools of assets owned by life insurance companies. They are distributed to the public under an information folder and insurance contract, rather than a prospectus, and are governed by insurance regulations. Group segregated funds are another category of segregated funds, typically distributed to capital accumulation plans.

ACCOUNTABILITY TO INVESTORS
Professional investment management of public money requires a comprehensive understanding of investment fund risk management. In the Study Group’s view, effective risk management requires an integrated approach and accountability to investors. Accountability may be viewed as “an obligation to answer for the discharge of
responsibilities.” Operating in a cooperative and supportive environment, the key stakeholders—the governing body, management, regulators and auditors—are partners in the accountability chain to investors. The ultimate accountability to investors, however, rests with an investment fund’s governing body.

For the most part, the structure and responsibilities of an investment fund’s governing body are determined by the legal and administrative framework within which the fund operates. An investment fund may be in the form of a trust (established by a declaration of trust), a partnership (governed by its partnership agreement) or a corporation (founded by articles of incorporation). The constating documents (declaration of trust or articles of incorporation) contain the investment objectives and other information dictating how the fund will carry on business.

One of the most widely used forms of organization for investment funds is the trust structure. From a governance perspective, however, the trust has few requirements for establishing governing bodies and providing ongoing governance. For investment funds organized as corporations, the legal requirements set out in the corporate statutes address matters such as the boards of directors, audit committees and annual meetings.

For purposes of this Research Report, the term “governing body” refers to the board of directors (or equivalent) of the fund manager in recognition that most funds, particularly mutual funds structured as trusts, do not have an internal governing body (such as an active board of directors or trustees). Investment funds generally operate through the fund manager. Accordingly, the term “governing body” generally refers to the fund manager and the governing body of the fund manager (that is, the fund manager’s board of directors).

INTEGRATED RISK MANAGEMENT

Integrated risk management has become increasingly prevalent in the investment fund industry. In today’s ever-changing business environment, a fund must satisfy the demands of its investors and strive to exceed the performance of its competitors. These forces make it imperative to control and manage risk comprehensively. This means that a fund’s risk profile must be continually reviewed to ensure that existing risks are monitored and stay within a tolerable level, and that new risks must be identified as soon as they arise.

Exhibit 1.1 illustrates that risk management is a continuous, evolving process that is relevant to all facets of a fund’s business. An investment fund’s risk management process encompasses a mission, objectives, risks and controls. In the Study Group’s view, the mission of a typical investment fund is to enhance investor value (that is, maximize performance returns within the fund’s mandate and within acceptable risk). To achieve its mission, a fund establishes specific objectives. Risk identification and assessment provides a basis for understanding the risks that may prevent those objectives from being met. Control identification and assessment provide the means for mitigating risks and, thereby, help to achieve the objectives and the fund’s mission.

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1 The key stakeholders differ from the primary users of financial statements, which are investors, financial advisers, financial analysts, management, industry regulators and, in certain cases, creditors.
To be meaningful, risk assessment must be linked to an investment fund’s objectives. As well, integrated risk management must be appropriate for the size and complexity of the business. Exhibit 1.2 provides a starting point for the risk management process by setting out a number of generic objectives for investment funds. It is important to note that, if a high level of risk exists, a specific objective or a set of sub-objectives may have to be established to deal with that risk.

**Exhibit 1.2**

<table>
<thead>
<tr>
<th>Investment Fund Objectives (Generic)</th>
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</thead>
<tbody>
<tr>
<td>• Maximize investment returns in relation to the investment objectives and policies.</td>
</tr>
<tr>
<td>• Safeguard the interests of investors within the fund’s prescribed mandate.</td>
</tr>
<tr>
<td>• Provide a level of service, including useful reporting, that meets investor needs.</td>
</tr>
<tr>
<td>• Ensure operating procedures and controls are established to effectively manage risk.</td>
</tr>
<tr>
<td>• Minimize fund expenses within an acceptable standard of service.</td>
</tr>
<tr>
<td>• Ensure safekeeping of fund assets.</td>
</tr>
<tr>
<td>• Operate the fund within the context of all relevant legal requirements.</td>
</tr>
<tr>
<td>• Protect the reputation of the fund and the fund manager.</td>
</tr>
</tbody>
</table>

*Risk* is a factor or condition that would prevent the fund from meeting its objectives. It is also the possibility that one or more individuals or organizations will experience adverse consequences. The Study Group believes that it is crucial for a fund’s governing body, in conjunction with senior management, to identify the risks of not meeting the fund’s objectives and to specify the control measures that should be put in place to prevent unacceptable risks, manage and monitor acceptable risks and mitigate unexpected risks.

A risk management process should call for the identification of risks, as well as the implementation and assessment of control measures that may be used to mitigate risks related to a fund’s objectives. In this context, *control* is broader than traditional internal control over financial reporting, compliance and asset safeguarding. It encompasses all of the elements of an organization—its resources, systems, processes, culture, structure and tasks—that, taken together, support the achievement of an organization’s objectives.

In light of an investment fund’s accountability to investors, the Study Group proposes a risk/control framework for investment funds. Exhibit 1.3 shows the four areas covered by the framework: the nature of business (discussed in Chapter 2), governance (discussed in Chapter 3), operations (discussed in Chapters 4, 5 and 6), and compliance (discussed in Chapters 7 and 8).

Appendix A, Exhibit A1 presents that framework in its entirety, setting out the key risk elements associated with each component of the framework. In the Study Group’s view, an effective risk/control framework should operate equally well in all circumstances—under normal market conditions, in periods of market disruption and during times of business interruption.
Exhibit 1.3

INVESTMENT FUND RISK / CONTROL FRAMEWORK

<table>
<thead>
<tr>
<th>Nature of Business</th>
<th>Governance</th>
<th>Operations</th>
<th>Compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic Management</td>
<td>Leadership</td>
<td>Agency Relationships</td>
<td>Legal and Regulatory</td>
</tr>
<tr>
<td>Operating Environment</td>
<td>Stewardship</td>
<td>Valuation of Investments</td>
<td>Industry Practices</td>
</tr>
<tr>
<td>Regulatory Environment</td>
<td>Responsibility</td>
<td>Fund Accounting and Reporting</td>
<td>Taxation</td>
</tr>
<tr>
<td>Marketplace Environment</td>
<td>Accountability</td>
<td>Information Systems</td>
<td>Assurance Reports</td>
</tr>
</tbody>
</table>

The framework depicts the main components of an investment fund’s nature of business. As set out above, these components can be further divided into sub-categories. For example, strategic management could include fund performance, client service, product design and description, distribution channels, sales and marketing of product/fund to appropriate investors (know your client) and management integrity. The marketplace environment could include competition, complexity of fund structures, distribution strategies and financial risks.

The major components of governance can be broken down in similar fashion. Leadership, for example, might include independence and the governing body’s effectiveness and stewardship might include the mandate of the fund manager and the independent review committee, as well as the ethics program.

In turn, the primary components of an investment fund’s operations might be divided in the following way. Agency relationships generally include the fund’s
relationships with its investment adviser, transfer agent, custodian and others. *Fund accounting and reporting* might encompass calculation of the net asset value (NAV) per unit/share, pricing errors, financial reporting, management report on fund performance (MRFP), and performance reporting.

Lastly, the significant components of *compliance* could include *legal and regulatory* issues, encompassing investment objectives and restrictions, asset valuation and daily pricing, safeguarding of assets, reporting and continuous disclosure, sales practices, and fund manager registration. *Assurance reports* might encompass the audit of financial statements, compliance with National Instrument 81-102 and Companion Policy 81-102CP *Mutual Funds* issued by the Canadian Securities Administrators (CSA), prospectuses and annual reports, and other assurance services.

In the Study Group’s view, the proposed risk/control framework provides a sound basis for identifying, measuring, managing and monitoring risks and controls. For each part of the framework, this Research Report offers possible control measures that — individually or in combination — can be used to manage risk. Selecting appropriate control measures will require professional judgment and will depend on the nature and extent of the particular risks facing each investment fund. In all cases, process and controls should be documented.
Chapter 2

NATURE OF BUSINESS

Chapter 1 introduced the concept of an integrated risk/control framework separated into four broad areas—nature of business, governance, operations and compliance. This chapter addresses the first part of the Investment Fund Risk/Control Framework, which is reproduced below. It examines investment fund risks associated with the nature of the business.

Investment Fund Risk / Control Framework

<table>
<thead>
<tr>
<th>Part 1 - Nature of Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strategic Management</td>
</tr>
<tr>
<td>Operating Environment</td>
</tr>
<tr>
<td>Regulatory Environment</td>
</tr>
<tr>
<td>Marketplace Environment</td>
</tr>
</tbody>
</table>

The major components and key risk elements of an investment fund’s “nature of business” are:

- strategic management, which encompasses fund performance, client service, product design and description, distribution channels, sales and marketing of product/fund to appropriate investors (know your client) and management integrity;
- operating environment, which encompasses governance, operating structure, business continuity and information technology;
- regulatory environment, which encompasses legal structure and compliance requirements;
- marketplace environment, which encompasses competition, complexity of fund structures, distribution strategies and financial risks.

STRATEGIC MANAGEMENT

Strategic management focuses on the factors that impact the success or failure of an investment fund in achieving its objectives. From a fund manager's perspective, success is gauged by the ability of the fund to attract and retain investors and to grow assets under management. It is important, therefore, to consider why investors would choose one fund over another. Often, the choice is based on a combination of performance (of the fund manager, the fund and the investment adviser), the ability of the fund manager and the fund to deliver on stated objectives, client service, product design and development, sales and marketing (including investment adviser and dealer compensation), the distribution channels used, expense ratios and management integrity. The following discussion examines each of these critical success factors and how they may relate to the investment fund, the fund manager, or both.

Performance

Consistent achievement of the fund’s investment objective is important to the continued success of any investment fund. Considerations for assessing fund performance include the investment objective; volatility of performance; the nature and extent of performance disclosures; the level of investor costs, including transactions and trading costs; comparative funds; benchmarks and targets; and the type of market. Consistent, above-average performance is also important for attracting and retaining investors in the specific funds.

The ability of an investment adviser to deliver consistent above average performance is generally a function of a sound investment process and the ability of the adviser to attract and retain investment professionals who can effectively and consistently adhere to the process. These investment professionals are the primary intellectual capital of the adviser and their departure can lead to a reduction in investor confidence, negative impacts on performance and negative public relations for the related fund and fund manager. All of these factors
could lead to redemptions from a fund and curtailment of future sales.

Therefore, when assessing the risk and impact of investment professionals departing from an adviser, consideration should be given to the following matters:

• Are the current compensation programs of the adviser competitive?
• Does the adviser promote “star” managers whereby a single individual is very closely linked to the performance of a given fund thereby exposing that fund to greater impacts should that individual depart?
• How clearly is the investment process articulated and understood by the entire investment team?
• What succession plans have been developed to replace individuals who are critical to the investment process and/or the distribution of the funds?
• Does the adviser have a policy whereby portfolio management and analysis functions are rotated on a regular basis allowing for backup capabilities to be developed in all critical areas?

Client Service
Excellent client service might include providing timely, accurate and complete information, investor education, personalized advice and effective financial planning (offered either directly by the fund company or by a third-party distributor). Considerations for assessing client service include lines of communication; meeting current demands; deployment of human resources; cost to deliver; staying abreast of the competition; and existing/evolving regulatory requirements.

Product Design and Development
Investors continue to demand new and innovative products to meet their ongoing investment objectives, prompting fund managers to constantly develop and market new funds. Occasionally, a fund manager or governing body may wish to reorganize a fund for economic or other business reasons. Reorganizations include activities such as wind-ups, mergers, changes in legal status, and changes to the expense structure of a fund. Considerations for assessing product design include product features (such as guarantees, leverage and/or tax treatment); distribution channels; pricing structures; changing demographics and trends; existing/evolving regulatory and political environments; new entrants beyond the current competition; and new fund launches.

Sales and Marketing
Sales and marketing are essential to establishing and promoting an investment fund’s (and fund manager’s) brand name, reputation and differentiation. Considerations for assessing sales and marketing include relationships between the fund, its manager and the distributor(s); relationships between the fund and investors; the fund manager’s reputation and position in the marketplace (particularly for funds marketing to institutional investors); the fund’s level of complexity; the choice and compensation of distribution channels; load structures; the availability of funds; individual fund profitability; and compliance with fiduciary responsibilities and existing/evolving regulatory environments.

Distribution Channels
The choice of distribution channels is an essential part of sales and marketing. The primary distribution channels for retail investment funds are mutual fund dealers, bank branch networks and investment dealers, financial planners licensed to sell mutual funds, and direct marketing approaches. Institutional investment funds are usually distributed directly or through consulting firms to plan sponsors. Considerations for assessing the choice of distribution channels include nature of the product being offered; whether members of the various distribution channels are permitted to sell the product being offered under their registration category; and the varying costs of the distribution channels.
Management Integrity
A key factor that influences the continued success or failure of an investment fund is the integrity of the fund’s management. This assessment includes considering matters such as the reputation of management and whether it is perceived as being trustworthy and is well-respected; maintenance of high standards; adherence to a code of ethics; mindset toward compliance with legal and regulatory requirements; style of communications and consistency of messages; level of social responsibility; public perceptions; and associations with service providers and third parties. As well, the managers of investment funds are fiduciaries and are, therefore, required to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in similar circumstances.

OPERATING ENVIRONMENT
Assessing business risks inherent in an investment fund’s operating environment starts with a sound understanding of how a fund plans to meet its stated investment objectives. What governance structure has been established? What operating structure is in place, including risk management, human resources, various servicing agency relationships and the integrity of net asset value data? Is there an appropriate business continuity plan for both the fund manager and for the funds it manages?

Governance
Governance may be broadly defined as the authoritative direction or control over an entity that encompasses roles, relationships, powers and accountabilities. In other words, it refers to who is in charge, who sets direction, who makes decisions, who monitors progress and who is accountable for the performance of the entity. The structure and responsibilities of an investment fund’s governing body are determined by the legal and administrative framework within which the fund operates. Investment funds will generally be in the form of a trust established by declaration of trust, a corporation founded by articles of incorporation or a limited partnership governed by its partnership agreement.

In an investment fund context, governance is driven by accountability to investors and focuses on the leadership of the governing body in discharging its stewardship obligations and in fulfilling its responsibility. As previously noted, the term “governing body” refers to the board of directors (or equivalent) of the fund manager in recognition that most funds, particularly mutual funds structured as trusts, do not have an internal governing body (such as an active board of directors or trustees). The governing body has a responsibility to oversee the conduct of the business, monitor management and ensure that all major issues affecting the fund’s business and affairs are given proper consideration in the best interests of the investors.

An additional element of governance might be provided by a fund’s independent review committee (IRC). All investment funds that are reporting issuers (products offered by prospectus) are required to have an IRC comprising members that are independent of the fund manager, the fund itself and any entities related to the fund manager.²

Chapter 3 of this report reviews, in detail, the four major risk components of governance (leadership, stewardship, responsibility and accountability) and the pertinent risk elements and control measures.

Operating Structure
Exhibit 2.1 depicts the typical organization of a mutual fund. Service organizations or agents may include a custodian, an investment adviser, a distributor, a transfer agent and fund accountant. The significant fund activities (including custodianship, portfolio management

² Generally, funds become reporting issuers in Canada by filing and receiving a receipt from the securities regulators for a prospectus.
and trading, the sale of units/shares, administration and recordkeeping) may be performed in-house, outsourced, or a combination of both. A servicing organization or agent may handle several of these functions.

In general, the fund manager is legally accountable for all aspects of fund management. For example, NI 81-102 (Section 4.4, Liability and Indemnification) states that a mutual fund shall not relieve the fund manager for loss or liability that arises out of the failure of the fund manager to exercise the powers and discharge the duties of its office in good faith and in the best interests of the mutual fund. Proposed National Instrument 31-103 Registration Requirements makes the regulatory expectations more explicit and holds the fund manager accountable for all aspects of fund management, whether contracted out or performed in-house.³ This view is consistent with the view currently held by most securities regulators worldwide. The fund’s investment adviser provides investment advice to the fund manager and the fund on the composition of the investment portfolio.

Normally, the fund manager sponsors the fund, provides the initial seed capital, markets it to investors and is responsible for its day-to-day operations.⁴ The fund manager’s responsibilities and relationship with the fund are usually set out in a management agreement. As compensation, the manager receives a management fee, which is normally calculated as a specific percentage of the fund’s net asset value. Management fee rates vary depending on the type of fund and certain other factors. When third-party servicing agents carry out responsibilities covered by the management fee, the manager directly or indirectly shares this fee with those agents.

Some investment advisers may also charge a performance or incentive fee, which is calculated based on performance of the fund. These types of fees vary, from simple arrangements involving a percentage of profits earned, to complicated calculations involving hurdles that must be met before a performance or incentive fee is earned. Any performance or incentive fees for conventional funds have to be in accordance with the requirements of NI 81-102 (Part 7).

Securities regulations impose an objective standard of care on a fund manager, who may also be the trustee of

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³ The proposed rule was first published for comment in February 2007 and was re-released for a second comment period in February 2008. The comment period ended in May 2008. The original implementation date was March 2009. The CSA announced in November 2008 that a revised implementation timetable would be developed and announced in April 2009.

⁴ National Instrument 81-102 Mutual Funds, states that manager refers to a person or company that directs a mutual fund’s business, operations and affairs. Draft NI 31-103 requires that managers of investment funds be registered with the securities regulators. Managers will then generally be subject to registration requirements, including capital, insurance and proficiency.
the fund, and limit the transactions that related parties can carry out. Common law imposes a fiduciary duty on investment advisers. Trustees are governed by common law as well as provincial and federal trust legislation. Individual declarations of trust for mutual funds also prescribe (via contract) codes of conduct for the management of an investment fund’s business affairs.

The fund manager is responsible for the provision of all services to the fund (for example, recordkeeping, fund accounting, back-office order processing). As above, regardless of whether the fund manager performs these services directly or contracts them out to third parties, the securities regulators hold the fund manager responsible for these services.

A statutory standard of care requires the manager to take into account the best interests of the fund when engaging service providers. Part of the fund manager’s responsibility is to ensure that a service provider has adequate resources and expertise to properly perform the functions contracted out to it. As a result, the fund manager should have adequate policies and procedures in place to ensure appropriate oversight of service providers.

The IOSCO outsourcing principles cover seven areas—due diligence in selecting a service provider, the contract with a service provider, business continuity, client confidentiality, concentration of outsourcing services, termination procedures and access to books and records. Central to the principles are a set of performance standards that provide that the outsourcing firm, its management and governing authority must retain full legal liability and accountability to the regulator for all outsourced functions. In Canada, the outsourcing firm in the investment fund context is generally the fund manager.6

Managers of investment funds—whether or not they are currently registered as investment advisers or dealers—must adopt operating policies and procedures to ensure proper administration and management of investment funds they manage, including proper operation of their business as a fund manager. Such policies and procedures should conform to regulations, and prudent business practices, as well as provide for supervision as is appropriate or necessary. In addition, managers of investment funds should adopt a code of conduct that employees of manager member firms must follow. The code of conduct should cover personal trading, self dealing and other conflicts.

It is important to note that investment funds normally have no employees of their own. The fund manager is generally responsible for a fund’s day-to-day operations and for administering all necessary services, facilities and personnel required to carry out a fund’s activities. Exhibit 2.2 provides an illustrative overview of investment fund operations and depicts the cash flows and/or information flows for a typical investment fund and its service providers.

The major risk components of operations and the pertinent risk elements are addressed in Chapters 4, 5 and 6 of this Research Report. The discussion of each risk element includes control measures that merit consideration by management, regulators and auditors.

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5 Mutual funds are governed by legislated prohibitions on transactions with related parties and self-dealing set out in securities legislation, including National Instrument 81-102, although such transactions may occur if the fund obtains exemptive relief or, in certain circumstances, approval from an IRC.

Assessing Risks & Controls of Investment Funds

Exhibit 2.2

Illustrative Overview of Investment Fund Operations

- Investors
- Distribution Channels
- Trust Accounting (cash held in trust)
- Marketing and Sales
- Transfer Agent
- Fund Accounting (NAV calculation)
- Custodian (assets in safekeeping)
- Portfolio Management & Investment Operations

Operating risks
Investment funds are subject to various operational risks including those emanating from:

- agency relationships;
- valuation of investments;
- fund accounting and reporting; and
- information systems.

The following are examples of risks that merit consideration:

- the risk that improper valuations are used to price fund units/shares;
- the risk that the fund may be unable to pay out redemption requests when received;
- the ability to effect purchases and sales to continually meet the fund’s investment objective;
- reliance on the fund manager to effect decisions on behalf of the fund;
- the risk that a fund may be delayed or unable to settle a transaction; and
- the risk that the fund manager may not be able to pay expenses of the funds as incurred.

Integrity of operations
The integrity of operations ultimately resulting in determining the NAV per security includes consideration of matters such as: the recording of investment transactions and unit/share sales and redeemptions; the regular accrual of interest and dividend income and expenses; and the valuation of investments. NAV per security data is crucial to an investment fund and its investors because it represents the price at which units or shares are bought and sold on any particular day. It is also important to investors as it represents the price used to calculate the value of their investment in the fund at any given time and to monitor the fund’s performance.

Business Continuity and Contingency Planning
In addition to governance and operating structures, an investment fund’s operating environment encompasses
business continuity considerations. Close business working relationships among investment funds, fund managers and their servicing agencies are now commonplace. Because mutual funds generally sell and redeem units/shares daily, virtually any disruption in services can have serious repercussions. As well, a disruption in services could also have a serious impact on the ability of a fund manager to execute trades to meet a fund’s investment objective. It is crucial, therefore, that fund managers have a solid understanding of the business continuity risks they and their funds face, as well as have a well-thought-out process in place to deal effectively with those risks. The business continuity planning process must be integrated across all areas of an investment funds operations, including all servicing agencies.7

Electronic commerce introduces its own new vulnerabilities because fund managers are bound up and down the supply chain with intranets, extranets or other electronic ties to investors, service providers and regulatory agencies. Exposure to intrusions and potential leaks of sensitive data used in electronic commerce is further evidence of the need for business continuity plans (both at the investment fund level and at the fund manager level).

According to the Canadian Securities Administrators (CSA), good business practice requires all market participants to implement contingency planning. As a minimum, individual dealers, advisers, exchanges, clearing corporations, custodians, systems providers and other market participants should assess the potential risks of failure of their core business processes, establish strategies to deal with those risks (including a plan to test these strategies) and update the strategies as new information becomes available.

In its simplest form, a contingency planning process has three stages:
• creating an inventory of the processes and resources that are vital to the success of a fund;
• assessing the risk of failure and subsequent impact that a failure would have on the fund; and
• developing the contingency plan itself.

To develop contingency plans, organizations need to determine which processes are crucial to their business and on what resources those processes depend. Resources that might fail extend beyond computer hardware and software. Resources that are normally very reliable, including power and telephone services, may suffer disruptions. Organizations need to consider a broad group of resources and processes when they are starting the contingency planning process.

Once processes and resources have been fully inventoried, the next step is to measure the risk of disruption for each process, relationship, dependency and resource. When developing contingency plans, organizations must create solutions that address a potential failure. Many of the support services taken for granted may not be available, limiting an organization’s ability to cope with a problem. Organizations need to plan proactively for failures in infrastructure and firmware.

**Information Technology**

Information technology systems affect many areas of an investment fund’s operations, including portfolio management, accounting and investor servicing. Consequently, technology-related problems in these areas could adversely affect both investment funds and their investors (information systems and technology issues are discussed in Chapter 6).

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REGULATORY ENVIRONMENT

An investment fund’s regulatory environment covers both legal and compliance matters. The regulated nature of the investment fund industry and the impact that noncompliance with certain regulations could have on an investment fund, suggest that regulatory compliance be carefully considered when addressing inherent risk. Because investment funds vary considerably, it is important that a fund’s business objective, tax consequences and regulatory regime be clearly understood by those responsible for the fund management and oversight.

Assessing the risks in an investment fund’s regulatory environment starts with a sound understanding of the fund’s legal structure and compliance requirements. This includes management’s attitude toward compliance, management’s experience with, or knowledge of, compliance issues, and whether there are systems in place to ensure compliance with regulations and to monitor legislation for changes.

Legal Structure

Investment funds are generally organized as trusts, corporations or limited partnerships. Although each of these legal structures has similarities, each also has unique characteristics, such as tax consequences, liability and governance structure. For securities law purposes, each investment fund is considered to be a separate legal entity and reporting issuer.

Many investment funds in Canada are organized as unit trusts. Conventional investment funds (called mutual funds) are governed by securities regulations and are distributed to the public under a simplified prospectus filed with the securities commissions. An investment fund holds a pool of assets that is legally owned by a trustee and beneficially owned by the fund’s investors. An investment fund may also be organized as a corporation, in which case the corporation has legal and beneficial ownership of the underlying assets, and investors have the same rights as shareholders of business corporations under corporate law. Investors in investment funds organized as limited partnerships have legal and beneficial ownership of the fund’s assets.

Investment funds may also be organized as closed-end funds or as exchange-traded funds (ETFs). Both closed-end funds and ETFs are also governed by securities regulations and sold under a prospectus filed with the securities regulators. Closed-end funds are pooled investment funds that issue a fixed number of shares. Most closed-end funds trade at either a premium or a discount from NAV per security. ETFs are quasi open-end mutual fund trusts that generally hold stocks in the same proportion as a specified index. ETFs generally trade at or near NAV per security.

Segregated funds are another form of investment fund. Retail segregated funds, which are distributed to the public under an information folder and insurance contract, are governed by insurance regulations. Group segregated funds are similar but do not require an information folder; they are distributed through group plans, typically through employer-sponsored plans. A segregated fund holds a pool of assets that is legally owned by the insurance company and beneficially owned by the fund’s investors (who also hold an insurance policy).

An investment fund’s investors have statutory, property and contractual rights (under trust agreements or declarations of trust in the case of trustee mutual funds). Generally, investors bear all of the risk of market losses in a fund’s assets. Restrictions on the types of investments that most investment funds can make and the investment practices they follow, are designed to ensure that the funds are not exposed to greater claims than the market value of assets held.
The legal structure of an investment fund is heavily influenced by tax legislation, which can have a significant impact on the flow-through of income and gains to investors and on the withholding taxes on foreign income. It is important to be aware of the tax legislation a fund is subject to and whether the fund has complied with that legislation throughout the year. Failure to comply with tax legislation could have a significant impact on both the fund’s and/or investor’s tax position.

Most investment funds sold in Canada are not guaranteed in any fashion, although certain funds have features that provide some form of capital protection.

**Compliance Requirements**

Conventional investment funds (mutual funds) and segregated funds are subject to regulations that cover matters such as investment objectives and restrictions, asset valuation and daily pricing, trust accounts, reporting and disclosure, sales practices and continuous disclosure.

Chapters 7 and 8 deal with the major risk components of compliance and the pertinent risk elements. The discussion of each risk element includes control measures that merit consideration by management, regulators and auditors.

Although the separate provincial and territorial securities regulators oversee Canadian securities regulation of mutual funds, closed-end funds and ETFs, the Canadian Securities Administrators ensure that regulation is consistent, and consistently applied, across Canada. The main requirements governing mutual funds are:

- National Instrument 81-101 *Mutual Fund Prospectus Disclosure*;
- National Instrument 81-102 *Mutual Funds*;
- National Instrument 81-105 *Mutual Fund Sales Practices*; and
- securities legislation (Ontario Securities Act, Part 21 and equivalent in other jurisdictions).

Other requirements affecting most types of investment funds are:

- National Instrument 81-106 *Investment Fund Continuous Disclosure*;
- National Instrument 81-107 *Independent Review Committee for Investment Funds*; and

For mortgage funds, National Policy No. 29 *Mortgage Mutual Funds* remains generally applicable.

As well, proposed National Instrument 31-103 *Registration Requirements* will impose increased registration requirements on investment advisers and dealers and new registration requirements and ongoing conduct rules on most fund managers, excluding managers of segregated funds. Currently, some of these requirements are set out in provincial securities legislation and regulations. Listed investment funds (such as ETFs and some closed-end funds) are also subject to the rules and regulations of the applicable stock exchange.

Investment funds and their investment advisers, fund managers, custodians and distributors are also subject to various other federal and provincial legislation and regulations, including laws dealing with anti-money laundering and anti-terrorist financing\(^8\) and privacy,\(^9\) as well as, in the case of distributors, the requirements of the self regulatory organizations.

The regulation of segregated funds is governed by federal and provincial insurance legislation, which sets out requirements for the marketing and disclosure of

\(^8\) For guidance material and current events information, refer to the CICA AML Online Resource Centre.

\(^9\) For guidance material and current events information, refer to the CICA Online Privacy Resource Centre.
segregated funds and incorporates certain standards for the management of segregated fund assets.

To gain an understanding of a particular type of investment fund, it is important to be aware of the securities acts and other regulations that govern the fund. Generally, an investment fund’s securities cannot be sold to the public without an appropriate disclosure document being filed with the securities or other regulators and delivered to purchasers.

In this context, investment funds are no different than any other issuer of securities to the public. Securities regulators impose regulations on the sale of products, product structure and management. Regulation is currently based on two central principles: (1) ensuring full disclosure to investors of information relating to the funds and (2) the licensing and registration of investment advisers and distributors of funds. Proposed NI 31-103 also addresses the registration of most fund managers. Each category of registration has its own proficiency, insurance and capital requirements appropriate to the nature of the entity involved and its business risk.

Mutual funds must prepare and make available to investors annual audited financial statements and semi-annual unaudited financial statements, as well as annual and semi-annual management reports of fund performance. Mutual funds are also required to comply with applicable “material change” filing requirements that include amending prospectuses and issuing press releases in the event of a material change to the affairs of a fund.

Fund managers are prohibited from taking any action without IRC approval for certain specified conflicts (for example, inter-fund trading or purchasing or holding securities issued by issuers related to the fund manager), as explained in Chapter 3. Before other fundamental changes are made (such as a change in fees, a change in fund manager, a decrease in the frequency of calculation of NAV per security, or a change in a mutual fund’s investment objective), investors must give their approval at a duly called investors’ meeting. In some cases, these fundamental changes may require the approval of securities regulators.

Fund managers that are not also investment advisers are not currently required to be registered with the securities regulators. They are, however, subject to an objective legislated standard of care. Proposed NI 31-103 Registration Requirements will add registration requirements for most fund managers (other than managers of segregated funds) including, in some cases, requirements for capital, insurance and proficiency. Dealers and investment advisers must be registered with the securities regulators.

The portfolio manager of an investment fund must be registered with securities regulators as an “adviser” in the categories of investment counsel and portfolio manager. A distributor of a fund’s securities must also be registered with the securities regulators as a dealer (mutual fund dealer or investment dealer). Securities regulators have recognized self-regulatory organizations to directly supervise dealer activities (subject to oversight by the securities regulators). Custodianship of mutual fund assets must generally be carried out by a third-party custodian that is a bank or trust company or affiliate. Custodians of assets held by mutual funds are also subject to an objective standard of care under securities regulation.

**MARKETPLACE ENVIRONMENT**

An investment fund’s marketplace environment includes the key elements of competition, complexity of fund structures, distribution strategies, operating risks and financial risks.
Nature of Business

Competition

Participants in Canada’s investment funds industry are key players in the Canadian financial services sector. The industry is highly competitive, with assets spread across a variety of products, including mutual funds, segregated funds, pooled funds, pension funds, structured products, hedge funds and other alternatives.

Complexity of Fund Structures

A significant part of the investment funds industry is developing new products and capital structures tailored to meet emerging needs. In Canada, some investment funds adopt complex capital structures to increase flexibility and access to alternative distribution channels for their units/shares. Those structures include multiple-class funds, fund-of-funds, hedge funds and structured products.

Multiple-class funds issue more than one class (or series) of units/shares. Each class may have different attributes, such as a different type of sales charge or different distribution characteristics, and may be charged for expenses that relate specifically to that class. Multiple-class funds raise unique operational and accounting issues, such as the allocation of income, expenses, gains and losses to the various classes necessary to determine the NAV per security for each class; the calculation of dividends and distributions for each class; and the calculation of investment performance for each class.

There are also multi-class corporate mutual funds where each class is referenced to its own portfolio of investments. NI 81-102 Part 1.3 considers each such class to be a separate mutual fund for regulatory purposes. Mutual funds subject to NI 81-102 may only invest in other mutual funds that are themselves subject to NI 81-102 and must comply with prescribed “fund of fund” rules set out in NI 81-102.

Fund-of-funds are investment funds that invest in other investment funds. These may include offshore, domestic and blended structure programs. A blended structure might include a fund with significant investments in other investment funds and also investments in individual securities.

Hedge funds may take the form of trusts or limited partnerships. Hedge funds may invest directly in complex securities or through fund-of-fund structures including master-feeder structures. Under the master/feeder structure, the investment management and distribution functions are performed separately. Feeder funds invest their assets solely in another investment fund, known as the master fund. Both have the same investment objectives. The master fund performs all investment management functions, whereas the feeders look after the distribution, investor servicing and transfer agent functions. This master/feeder structure allows each fund’s services and fees to be tailored to a specific market segment and provides economies of scale through a centralized investment portfolio. Master/feeder accounting issues include the allocation of the master fund’s income, expenses, gains and losses to the feeder funds. Sophisticated accounting systems are required to record these items because the relative interest of the feeder funds may change daily as units/shares are sold or redeemed.

Investment products may be structured to provide tax-effective returns (capital gains instead of income) or to provide retail investors with opportunities to invest in securities that otherwise may not be readily available to them (for example, credit-backed notes) or offering the feature of two or more classes of shares to meet varying investor risk profiles (for example, split corporations offer two share classes: one with a fixed coupon note and another entitled to the residual and most of the risks and rewards, thus leveraging the investment and returns to those of the fixed coupon rate investors). Often, such structured products are offered as “closed end” and listed on an exchange.
Distribution Strategies
In Canada, the primary distribution channels for investment funds are mutual fund dealers, bank branch networks, investment dealers and financial planners licensed to sell mutual funds. Some mutual funds are distributed using direct marketing approaches, such as through discount brokers and mutual fund dealers, who use electronic commerce techniques. In all cases, a registered dealer must be involved. As well, some investment funds are sold privately under exemptions from securities legislation (e.g., offering memorandum). Many different products are available through different distribution channels in response to expanding demands for product line by distributors and access by investors. Key elements of the distribution strategy include the compensation of the distribution channel, the service model desired and the costs involved in accessing the distributors and clients.

Financial Risks
As participants in capital markets, investment funds are subject to many of the same risks as financial institutions. Continued pressure for better performance, innovations in securities instruments, a complex investment environment and economic and political considerations emphasize the importance of assessing the financial risks associated with the management of a securities portfolio. Sound portfolio management involves prudently managing the risk/reward relationship and controlling risks across a variety of dimensions, such as quality, portfolio concentration/diversification, maturity, volatility, marketability, type of security and the need to maintain adequate liquidity. In this respect, the key elements of financial risk for investment funds are market risk, credit risk, interest rate risk, foreign exchange risk and liquidity risk.

Market risk
Market risk is the risk of loss resulting from changes in the prices of financial instruments in the markets where an investment fund invests (for example, as a result of stock volatility).

Credit risk
Credit risk is the risk of financial loss, despite realization of collateral security or property, resulting from the failure of a debtor, for any reason, to honour its obligations. Credit risk encompasses a financial loss occurring as a result of default by a borrower or counterparty on its obligation to the investment fund. It also includes the risk of loss resulting from a downgrade of the debtor. Counterparty risk is the risk of default by counterparties to forward contracts, and to other contractual arrangements, including swaps and trades.10

Interest rate risk
Interest rate risk is the potential for financial loss arising from changes in interest rates.

Foreign exchange risk
Foreign exchange risk is the potential for financial loss arising from changes in foreign exchange rates.

Liquidity risk
Liquidity is the availability of funds, or assurance that funds will be available, to honour all cash outflow commitments as they arise. These commitments are generally met through cash inflows, assets readily convertible to cash or the capacity to borrow. Meeting commitments may become a challenge in time of extreme market stress, whether relating to a single security or a market as a whole. It may also become an issue for labour-sponsored investment fund corporations, mortgage funds and real estate funds whose investments, by nature, are generally less liquid than listed securities.

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10 Also refer to EIC-173, Credit Risk and the Fair Value of Financial Assets and Financial Liabilities as to whether an entity’s own credit risk and the credit risk of the counterparty should be taken into account in determining the fair value of financial assets and financial liabilities, including derivative instruments, for presentation and disclosure purposes.
Chapter 1 introduced the concept of an integrated risk/control framework separated into four broad areas—nature of business, governance, operations and compliance. This chapter addresses the second part of the Investment Fund Risk/Control Framework, which is reproduced below. It examines how investment fund governance applies to both investment funds and their managers.

<table>
<thead>
<tr>
<th>Leadership</th>
<th>Stewardship</th>
<th>Responsibility</th>
<th>Accountability</th>
</tr>
</thead>
</table>

The major components and key risk elements of an investment fund’s “governance” are:

- leadership, which encompasses independence and effectiveness of the governing body;
- stewardship, which encompasses the mandate of the fund manager and the independent review committee as well as the ethics program;
- responsibility, which encompasses the oversight of conflicts of interest and risk management;
- accountability, which encompasses the oversight of the financial reporting process and communications.

**APPROACHES TO INVESTMENT FUND GOVERNANCE**

Investment funds in Canada are generally sponsored, promoted, managed and administered by fund managers. The fund manager has full responsibility for fund governance or for ensuring that an appropriate governance structure, in compliance with the regulations, is in place.

The principles of governance that apply to investment funds can be viewed as a direct result of the relationships among the fund manager (sponsor, promoter, administrator and manager), the investment funds themselves and their investors. Today’s fund governance practices have also developed in response to increased regulation by securities regulators.

Fund managers must manage investment funds according to fiduciary principles – the duty to act honestly, in good faith and in the best interests of the funds and the duty to exercise a minimum degree of care, diligence and skill. These central governance principles have been enshrined in Canadian securities legislation for decades.

Management of conflicts of interest flows from these fiduciary principles, and Canadian securities legislation has long contained restrictions and prohibitions on certain activities that are considered to raise significant conflicts of interest in the management of investment funds. Where it is impossible to avoid conflicts of interest, they must be managed, which may require that they be disclosed to fund investors.

For all practical purposes, the fund manager is responsible for all of an investment fund’s management and administrative duties, making the fund manager accountable for the fund’s operations through its own governance mechanisms. The fund manager’s accountability to the investment funds (and investors in those
funds) results from governance principles, as well as securities regulation.\textsuperscript{11}

With the significant increase in public investment in investment funds in the late 1980s and 1990s came increased regulatory and public debate, both in Canada and the United States, about whether it was necessary to improve investment fund governance. The Securities and Exchange Commission (SEC) in the United States chose to enhance several features of its fund governance approach that was first adopted in the 1940s, including the requirement that each investment fund have a board overseeing its management and administration.

In response, the Canadian securities regulators proposed an enhanced governance regime for publicly offered investment funds that built on existing Canadian securities regulation and, for the first time, would require fund managers to establish separate independent review committees to oversee certain aspects of their actions.\textsuperscript{12}

National Instrument 81-107 Independent Review Committee for Investment Funds, requires publicly offered investment funds to have an independent review committee (IRC) comprising members independent of the fund manager to oversee all decisions involving actual or perceived conflicts of interest a fund manager might face in the operation of the fund.\textsuperscript{13}

Regardless of whether a fund is set up as a trust or as a corporation, all investment funds that are reporting issuers are now required to have an independent review committee (IRC) comprising members that are independent of the fund manager, the fund itself and any entities related to the fund manager. The IRC is primarily responsible for considering and making decisions on those conflict of interest matters that require its approval under NI 81-107, including changes in the investment fund’s auditor, and considering and providing its recommendations on those conflict of interest matters that are referred to it for review by the fund manager in dealing with conflicts of interest between the fund manager and the manager’s duty to manage an investment fund.\textsuperscript{14}

Under NI 81-107, a fund manager must refer all conflicts of interest matters to the IRC before taking any action on such matters. Fund managers must consider the recommendations of the IRC in deciding what action to take, but are generally free to make decisions they believe are in the best interests of the funds. Fund managers are prohibited from taking any action without IRC approval for certain specific conflicts, however, such as inter-fund trading, purchasing or holding securities issued by issuers related to the fund manager and purchasing securities underwritten by related dealers within 60 days of the end of the distribution period for those securities. In addition, for publicly offered mutual funds, the IRC must approve certain mergers of mutual funds and any change in auditors.

NI 81-107 defines the term “conflict of interest matter” very broadly, using principles-based, reasonable person terminology. The instrument provides some examples of conflicts of interest, but otherwise clearly establishes that each fund manager must determine what conflicts of interest exist in its management and administration.

\begin{itemize}
  \item \textsuperscript{11} The International Organization of Securities Commissions (IOSCO) defined governance in the context of investment funds as “a framework for the organization and operation of CIS [collective investment scheme] that seeks to ensure that CIS are organized and operated efficiently and exclusively in the interests of CIS investors and not in the interests of CIS insiders.”. Refer to Examination of Governance for Collective Investment Schemes - Part I, a report of the Technical Committee of IOSCO, June 2006.
  \item \textsuperscript{12} Other governance documents include Making it Mutual: Aligning the Interests of Investors and Managers: Recommendations for a Mutual Fund Governance Regime in Canada (the “Erlichman Report”) issued in 2000 and a CSA Concept Proposal 81-402 Striking a New Balance: A Framework for Regulating Mutual Funds and their Managers issued in 2002.
  \item \textsuperscript{13} NI 81-107 was first issued in 2006 with a much more limited mandate.
  \item \textsuperscript{14} Refer to Appendix G for a review of NI 81-107 considerations for fund managers and IRCs.
\end{itemize}
of the investment funds. Fund managers, and not IRCs, are responsible for identifying conflicts of interest in their business.

A fund manager must have written policies and procedures describing how it manages any identified conflicts of interest and present these policies and procedures to the IRC for its consideration. The IRC must review and provide input on those policies and procedures before a fund manager can act on a conflict of interest matter.

While an IRC and a fund manager can agree that the IRC will take on additional functions, which would not be regulated by NI 81-107, NI 81-107 focuses on conflicts of interest experienced by fund managers, on the theory that a fund manager cannot be certain that it has met its fiduciary duties to the investment funds when it takes action on a particular conflict of interest matter.

The Risk/Control Framework presented in Chapter 1 identifies the four major components that serve as the cornerstones of effective governance:

- **Leadership**—the relationship between the “governors” and those “governed.”
- **Stewardship**—establishing goals, priorities and appropriate relationships.
- **Responsibility**—managing resources efficiently and effectively.
- **Accountability**—demonstrating and taking responsibility for the management of investment funds.

This chapter applies the elements making up each component to investment funds and their governance, pointing out where they fit in light of the unique relationships that apply to the Canadian investment fund industry. Many of the components discussed apply, in an investment fund context, to the fund manager, while others will be appropriate for the IRC.

**LEADERSHIP**

Governance fulfils a leadership function. Leadership is about the legal and ethical relationships between the governors and those governed. The key elements of leadership are independence and effectiveness.

Following is a brief description of each element and the related control measures that should be considered when assessing risk in the context of investment funds.

**Independence**

The objective of governance is to safeguard the interests of investors within the prescribed mandate of the fund. This requires the exercise of independent judgment. Independence is based on the absence of relationships and interests that could compromise, or could be perceived to compromise, the ability of a fund manager to exercise judgment in the best interests of the investors.

The traditional method of ensuring that fund managers exercise independent judgment when managing their investment funds has been through a combination of requiring them to adhere to fiduciary principles and restricting and prohibiting certain related party transactions that could compromise their independent judgment. It has been largely accepted that fiduciary principles will moderate fund managers’ actions and, therefore, safeguard investors’ interests. But, in situations where a fund manager does experience conflicts of interest, some additional element of independence is necessary. In such situations, Canadian fund governance recognizes that the manager’s decision making should take into account the recommendations from an independent body, the Independent Review Committee established under NI 81-107.

Under NI 81-107, the IRC of an investment fund must have at least three members and all of them must be independent of the fund manager. Members are considered independent if they have no material relationships.
with the investment fund, its manager or an entity related to that manager. The IRC is required to disclose annually its members and their relationships with the fund, manager or other service providers.

**Assessing independent judgment of the fund manager**
The Study Group believes that governance is enhanced when investment fund managers follow fiduciary principles in managing investment funds.

Control measures for assessing independence are presented in Exhibit 3.1.

### Exhibit 3.1

<table>
<thead>
<tr>
<th>Control Measures for Assessing Independence</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Fiduciary principles</strong></td>
</tr>
<tr>
<td>- Is the fund manager required by law to follow fiduciary principles in managing the investment fund?</td>
</tr>
<tr>
<td>- Does the fund manager demonstrate a high commitment to following fiduciary principles when making decisions about the administration and management of the funds?</td>
</tr>
<tr>
<td>- Does the fund manager assess the compliance regime to ensure adherence to high ethical and legal standards of conduct?</td>
</tr>
<tr>
<td><strong>B. Managing Conflicts of Interest and Oversight</strong></td>
</tr>
<tr>
<td>- How does the fund manager identify when it has a conflict of interest in managing the funds and how does it manage those conflicts of interest?</td>
</tr>
<tr>
<td>- Does the fund manager seek recommendations on what action it should take in light of the conflicts of interest from an independent body looking out for the best interests of the funds?</td>
</tr>
<tr>
<td>- Does it consider those recommendations in making decisions?</td>
</tr>
</tbody>
</table>

**Effectiveness**

A governing body’s *effectiveness* depends on how well that governing body discharges its roles and responsibilities as part of the overall control environment and in light of its mandate.

An assessment of a fund manager’s effectiveness should include all aspects of the manager’s operations, including considering its board of directors as its governing body, the knowledge, understanding, competence and effectiveness of the manager’s senior management and staff and the manager’s compliance culture. Compliance with regulatory requirements is key for assessing a fund manager’s effectiveness, which includes complete and accurate communications with investors in the funds and its adherence to fiduciary principles.

NI 81-107 reflects the emphasis on effectiveness of independent review committees. NI 81-107 requires the IRC to review its own effectiveness, as well as the effectiveness of its members, on an annual basis. This review must include an assessment of the IRC’s written charter, the competencies and knowledge of each member, and the time committed by each member to serve effectively on the Independent Review Committee. IRC independence and compensation must be considered as part of the annual assessment. The IRC must also review and assess the adequacy and effectiveness of the manager’s written policies and procedures on conflicts of interest.

**Assessing the effectiveness of the fund manager and the IRC**
The Study Group believes that governance is enhanced when the assessment of effectiveness addresses the structure, duties and responsibilities of the fund manager, as well as its compliance culture and its compliance with regulation and fiduciary principles.

Control measures for assessing effectiveness are presented in Exhibit 3.2.
Exhibit 3.2

Control Measures for Assessing Effectiveness

A. Compliance regime
- Is adherence to fiduciary principles emphasized by the fund manager?
- Does a culture of compliance exist?
- Does senior management of the fund manager exhibit the necessary "tone at the top" so that compliance with regulation and fiduciary principles is considered paramount?
- Does the board of directors consider the compliance regime of the fund manager on a regular basis?
- Are there appropriate reporting and escalation procedures for addressing compliance issues?

B. Conduct of Independent Review Committee
- Is there an appropriate balance of members with a suitable variety of skills and experience?
- Do members receive suitable information in support of agenda items (timely, reliable and sufficient and not overwhelming in quantity)?
- Are the members satisfied with the allocation of time to agenda items?
- Is the IRC satisfied with its decision-making process?
- Do members avoid excessive involvement in detail and in day-to-day management?
- Do the members meet without the presence of the fund manager, when appropriate, to discuss sensitive issues?
- Does the IRC appropriately address aspects of its effectiveness identified as needing improvement?

STEWARDSHIP

Stewardship is about establishing goals, priorities and appropriate relationships. As stewards, fund managers act for investors in managing the investment funds, and have responsibilities that are defined by fiduciary responsibilities, as well as compliance with legal requirements and ethics. They have responsibility for monitoring the management of the funds and are required to act solely in the best interests of the funds.

The key element of stewardship lies in the operations and actions of the fund manager. But, given the unique responsibilities of fund managers, stewardship for investment funds encompasses the manager’s responsibilities to meet its fiduciary responsibilities to the fund, including through its ethics program.

Following is a brief description of each element and the related control measures that should be considered when assessing risk.

Mandate of the Fund Manager and the IRC

Mandate of the fund manager deals with the role of the fund manager in establishing its powers, duties and responsibilities, keeping in mind the applicable regulations and fiduciary principles. This is generally part of the fund manager’s compliance regime, which it is required to maintain under applicable securities regulation.

NI 52-110 Audit Committees, NI 58-101 Disclosure of Corporate Governance Practices and NP 58-201 Corporate Governance Guidelines do not apply to investment funds or fund managers. Nonetheless, they set out principles of good corporate governance in Canada that might be relevant for a fund manager when considering its governance of investment funds.

The mandate of the IRC under NI 81-107 includes monitoring, reviewing and considering a fund manager’s strategies for managing conflicts of interest. Under NI 81-107, the IRC must adopt a written charter that includes its mandate, responsibilities and functions, and the policies and procedures it will follow when performing its functions.

Assessing the mandate of the fund manager and the IRC

The Study Group believes that governance is enhanced when a fund manager assumes responsibility for the stewardship of the investment funds by:
- clearly defining the powers, duties and responsibilities of the fund manager through a written and functioning compliance regime; and
- monitoring and reviewing and approving the fund manager’s methods of managing conflicts of interest on a periodic basis.

Control measures for assessing mandates are presented in Exhibit 3.3.
Exhibit 3.3

Control Measures for Assessing Mandate

A. Powers, duties and responsibilities
- Does the fund manager have a clearly established compliance regime that describes its powers, duties and responsibilities?
- Does the compliance regime include, for example, ensuring that conflict of interest policies and procedures are adequate and that input from the IRC is properly obtained and considered as appropriate?

B. Responsibilities of the IRC
- Has the IRC determined its mandate in accordance with NI 81-107?
- Do the fund manager and the IRC work together in ways that allow the IRC to properly carry out its mandate to provide independent judgment into the methods adopted by the fund manager to manage conflicts of interest?

Ethics Program

An ethics program, in the context of investment fund governance, deals with the role of the fund manager as guardian of its standards of conduct and ethical values in its administration and management of the investment funds. It may be appropriate for an IRC to monitor and oversee the fund manager’s ethics program where the fund manager considers that oversight of its ethics program raises conflicts of interest within the meaning of NI 81-107.

The values of an organization affect everything it does. They encompass ethical values, as well as matters such as creativity, innovation, quality and avoidance of bias in decision making. Values affect relationships with shareholders, customers, suppliers, employees and other stakeholders. They also affect the organization’s approach to matters such as compliance with the law, financial reporting and product quality. Unclear or inappropriate ethical values can have pervasive and significant impacts on the fund manager. They can lead to behaviour that results in communication breakdowns, loss of reputation, damage to customer relations, fraud and other illegal acts. Exhibit 3.4 highlights potential fraud risks in the investment fund industry by main areas of operation. It is not a comprehensive list of all types of frauds that could occur.

The Investment Funds Institute of Canada (IFIC) has provided guidance for fund managers by way of Guidelines for a Mutual Fund Manager Code of Ethics and the Final Report of the Code of Ethics Committee on Personal Investing. The IFIC guidelines address conflicts of interest, insider trading, self-dealing restrictions and cross-trading. The guidelines also deal with general obligations (fiduciary duty to act honestly, in good faith and in the best interests of the mutual funds and their investors and to exercise the proper degree of care, diligence and skill) and general compliance with laws.

The CFA Institute has also provided guidance through a Code of Ethics and Standards of Professional Conduct and has published the Asset Manager Code of Professional Conduct that sets out principles of conduct for professional asset managers.

Assessing the ethics program

The Study Group believes that governance is enhanced when a fund manager ensures that an effective ethics program is in place:
- to create and sustain an ethical culture that guides decision making;
- to demonstrate to investors, regulators and others that the fund manager’s ethics are soundly managed and that the fund manager is trustworthy;
- to educate management and employees about the fund manager’s principles and values and help them determine appropriate business practices and behaviour;
- to demonstrate that the fund manager is acting in accordance with fiduciary principles.

An effective ethics program for a fund manager could include:

15 Members of IFIC are expected to follow these guidelines. In the Study Group’s view, the guidelines serve as base standards against which others can be assessed.
Exhibit 3.4
Potential Fraud Risks

<table>
<thead>
<tr>
<th>Investment Activities</th>
<th>Transfer Agency Operations</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Front running by access persons (including all forms of intentionally circumventing insider trading/covered persons rules such as disclosure of relationships and portfolio holdings of the covered persons)</td>
<td>Falsifying non-financial changes to accounts (e.g. address, banking information, beneficiary elections), particularly on inactive/dormant accounts</td>
<td>Kiting (falsifying transfers between fund and trust bank accounts to misstate balances)</td>
</tr>
<tr>
<td>High closing in the markets</td>
<td>Cheque/wire frauds</td>
<td>Intentionally accepting clients to the funds who are not permitted under law to participate in the funds and falsifying records to hide</td>
</tr>
<tr>
<td>Permitting late trading to select clients/friends</td>
<td>Theft of redemption proceeds through redirection of payment/inputting false redemption orders and stealing the proceeds</td>
<td>Intentionally misleading investors or potential investors in marketing materials (e.g., regarding investment strategy, controls, reported investment returns)</td>
</tr>
<tr>
<td>Running a ponzi scheme</td>
<td>Intentionally charging trust accounts with corporate/manager expenses and hiding through falsified records</td>
<td>Intentionally timing write-downs of manually priced securities to achieve a desired result (such as crystallizing a performance fee)</td>
</tr>
<tr>
<td>Overriding controls to achieve a desired result, such as overstating prices obtained by the accounting agent/dept for securities</td>
<td>Falsifying documentation provided to external auditors or regulators</td>
<td></td>
</tr>
<tr>
<td>Burying trading errors so as to preempt reimbursement by manager</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Falsifying benchmark data used in computing performance fees</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Softer fraud – directing brokerage trades to parties that provide the manager with the best entertainment, and not necessarily the best service to the fund</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- a well-drafted and enforceable code of ethics and business conduct approved by the appropriate governing body;
- a “protected” mechanism for bringing complaints, concerns and code interpretation questions forward (commonly referred to as “whistleblower”); complainants should be assured about lack of retaliation, confidentiality to the extent possible and procedural fairness;
- an effective training and reinforcement program that seeks to communicate standards of proper business conduct;
- agreement to comply with the code as a condition of initial and continued employment, with compliance incorporated into business objectives as well as performance appraisals;
- accountability reporting mechanisms, including proper measurement, audit and feedback;
- regular reporting to the fund manager’s board of directors, or a special board committee, on matters including compliance reviews, program effectiveness and risk assessment, as well as establishing regular opportunities for member input;
- a tangible commitment by the fund manager’s senior management and board leadership in overseeing compliance with the code of ethics;
- periodic reporting to the board and to the IRC, as considered appropriate, on the nature of the manager’s ethics program and its compliance with such program.

Control measures for assessing the ethics program are presented in Exhibit 3.5.
Exhibit 3.5

Control Measures for Assessing the Ethics Program

A. Code of conduct
- Has the fund manager approved a suitable code of conduct?
- Do senior management and the board of the fund manager monitor the implementation of the code and the need for updating it in light of changes in the fund manager’s activities and investor expectations?

B. Policies
- Are there well-defined policies dealing with the fund manager’s conflicts of interest, fraud risks, including illegal acts, and business ethics?
- Are the policies combined with active systems for monitoring compliance with such policies?

C. Application
- Is the conduct of the fund manager, its senior management and its board consistent with the code?
- Do senior management and the board take the time to consider whether proposals presented for approval are “right” for the fund manager and its funds?
- Does the fund manager act in the best interest of the funds?

D. Monitoring
- Do the senior management and board of the fund manager receive appropriate reports from management on matters relating to ethical conduct, such as improper payments and related activities and conflicts of interest?
- Do the senior management and the board receive from management a report on the results of monitoring compliance with the fund manager’s code of conduct?
- Has the board asked the internal or external auditors to bring to its attention any proposal or action of which they are aware that they believe is inconsistent with the fund’s code of conduct?
- Does the fund manager consider its ethics program and compliance with its ethics program to be a conflict of interest matter within the meaning of NI 81-107? If so, does it bring its ethics program and its ongoing compliance to the IRC of the investment funds for its review and recommendations? Does it consider the recommendations of the IRC in making its decisions regarding its ethics program?

The ethics program is part of the fund manager’s overall control environment and forms the foundation for the fund manager’s processes and controls that address or mitigate the risks of fraud to the fund. In addition to a robust ethics program, anti-fraud programs might include the following elements:

- An effective internal audit function, including the nature and extent of activity and coverage, and the extent of the internal audit’s involvement and interaction with the fund’s governing body;
- Adequate oversight of financial reporting and internal control over financial reporting by the fund’s governing body;
- Whistleblower policy and related whistleblower or ethics hotline, including the company’s procedures for handling complaints and for accepting confidential submissions of concerns about questionable activities or matters;
- A well-defined organization structure, including policies and procedures related to the hiring, promotion, and compensation of key personnel;
- The entity’s risk assessment processes; and
- Controls that help to prevent misappropriation of assets (e.g., segregation of incompatible duties, authorization of assets, security systems).

RESPONSIBILITY

The fund manager of an investment fund has a responsibility to manage the funds efficiently and effectively, which includes ensuring that conflicts of interest are properly managed and that the process for managing conflicts of interest is properly documented in policies and procedures. Fund managers must act honestly and with good faith, and must possess appropriate competencies and skills. They are also expected to devote the time and energy required to ensure that governance is appropriate and adequate. The IRC has a key role in overseeing the methods the fund manager adopts to mitigate its conflicts of interest.

Oversight of Conflicts of Interest

Oversight deals with the IRC’s evaluation of the methods the fund manager has adopted to manage conflicts of interest. Under NI 81-107, the IRC must annually review the fund manager’s policies and procedures dealing with conflicts of interest, any standing instructions and the fund manager’s compliance with recommendations relating to conflicts of interest.
Assessing oversight of conflicts of interest

The Study Group believes that governance is enhanced when the fund manager assesses regularly which conflicts of interest it has when managing investment funds, and how it manages those conflicts of interest. Fund managers must take into account IRC recommendations on conflicts of interest that they have referred to the IRC. The IRC evaluates, at least annually, the fund manager’s approach to managing conflicts of interest.

Control measures for assessing oversight are presented in Exhibit 3.6.

Exhibit 3.6

Control Measures for Assessing Oversight of Conflicts of Interest

A. Management

- How well has the fund manager identified conflicts of interest in its management of the investment funds?
- What progress has been made in preparing, implementing and complying with any conflicts with management policies and procedures?
- Has the fund manager referred to and properly considered the IRC’s recommendations on the management of conflicts of interest?
- If the fund manager has not followed the recommendations of the IRC, does it consider that its actions were in the best interests of the funds?

B. Oversight

- Is the IRC competent and well motivated to consider conflicts of interest referred to it by the fund manager?
- What recommendations has the IRC given to the fund manager on the management of conflicts of interest?

Risk management

Risk management is key to the activities of the fund manager in properly managing the investment funds. Assessing risk management means evaluating information provided by management and others about the effectiveness of management “control” for a specified objective, and assessing the effectiveness of the fund manager in relation to that objective.

A fund manager’s board of directors will be integrally involved with the manager’s risk management of the business including those associated with its funds. Where an IRC exists, it will consider risk management issues only to extent that they relate to its mandate: to consider how the fund manager manages conflicts of interest referred to it.

A fund manager should explicitly assume responsibility for:

- the identification of the principal risks of its business and ensuring the implementation of appropriate systems to manage these risks;
- the integrity of internal control and management information systems.

Management control deals with the fund manager’s oversight of the systems used to achieve its objectives. These objectives may be broader than the safeguarding of assets and reliability of financial reporting addressed by the traditional internal control system. A fund manager’s approach to control for different objectives will place differing emphasis on tight central control (implemented through detailed procedural manuals), and less formal, decentralized control (implemented through people-oriented values and reward systems).

Management may use a number of functional areas to assist in managing risk for the organization. Larger organizations may have a centralized risk management department. The risk department is generally tasked with developing an enterprise-wide risk management framework to oversee and coordinate all the risk activities conducted within the organization. This framework assists management in ensuring that risks are being properly identified, assessed, managed, monitored and reported in accordance with established policies, procedures and guidelines. Other functional areas may support risk management (for example, internal audit, compliance, legal, finance and a chief financial officer/treasurer for the investment funds.

A fund manager’s board of directors can ask management to provide a report summarizing the extent to which
controls are effective, a description of significant risks accepted and a description of significant breakdowns in control and plans to address them. The board may also seek corroboration of management’s assessments. For example, the internal or external auditors may be asked to provide independent assurance about management’s assessment of control for a specified objective or to investigate areas of particular concern to the board.

Assessing risk management
The Study Group believes that governance is enhanced when the fund manager assumes responsibility for:

• identifying the principal risks of its business and ensuring that appropriate systems are implemented to manage these risks;
• the integrity of internal control and management information systems; and
• the adequacy of the business continuity and contingency planning.

An IRC will have some responsibility over these matters to the extent they relate to its mandate: to consider conflicts of interest referred to it by the fund manager.

Control measures for assessing risk management are presented in Exhibit 3.7.

ACCOUNTABILITY
Accountability is the obligation to answer for the discharge of responsibilities that affect others in important ways. It requires that all parties understand who is responsible for what, what information needs to be shared among the parties involved to form the basis for dialogue and what performance is to be achieved. Accountability will generally apply to the fund manager’s board of directors. Key elements of accountability are oversight of the financial reporting process and communications.

The following is a brief description of these elements and the related control measures that should be considered when assessing risk for investment funds.

Oversight of the Financial Reporting Process
Oversight of the financial reporting process deals with the fund manager’s responsibility to establish or assume the role of an oversight body, with appropriately defined duties for matters such as the review of the fund’s financial reporting activities, oversight of management reporting on internal control and direct communications with the internal and external auditors.

National Instrument 52-110 Audit Committees defines an audit committee as “a committee (or equivalent body) established by and among the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer, and, if no such committee exists, the entire board of directors of the issuer.” NI 52-110 outlines the audit committee’s responsibilities, as well as requirements for the composition and authority of that committee. Although NI 52-110 does not apply to investment funds or fund managers, the fund manager’s board of directors can use NI 52-110 as a guideline in establishing its role (or that of a board committee) as a body having oversight responsibility for the financial reporting process for investment funds.
Exhibit 3.7

Control Measures for Assessing Risk Management

A. Approach
• What overall approach to control does the fund manager seek to establish?
• Has there been a current assessment of how reliable its systems need to be?
• Does responsibility for control not only encompass financial reporting but also management reporting, operating efficiency and effectiveness and compliance with laws, regulations and policies?
• Are there formal mandates for boards and all board committees, as well as key management committees (for example, executive committees)?
• Does the fund manager demand reliable information from its service organizations?
• Is the fund manager’s style characterized by proactive planning or responding to crises?
• What importance does the fund manager place on compliance with investment policies and tax and securities regulations, including the procedures for monitoring such compliance?
• Have policies and procedures been established to identify and manage potential conflicts of interest, such as trade allocations, personal trading, the allocation of shared expenses and related party transactions?
• Does the internal audit department report to an appropriate level of management and have open access to the fund manager’s board of directors?
• Do the responsibilities of internal audit include monitoring compliance with the investment funds’ investment policies and tax and securities regulations applicable to the funds?
• Are the responsibilities for initiating transactions, recording transactions and maintaining custody over assets segregated?
• Is there appropriate interaction with and control over third-party service organizations responsible for providing or processing data necessary for the preparation of financial statements or the preparation of internal management information?
• Is the fund manager aware of areas where there are incompatible duties?

B. Risk identification
• How are major risks and opportunities identified and related control objectives set?
• How are new risks, opportunities and control requirements identified?
• Do employees with control responsibility have the necessary capability (for example, knowledge, skills, technology, budget)?
• Are control systems monitored for effectiveness?

C. Risk control
• How are responsibility and accountability for control established?
• Are there clear roles and responsibilities for management, for the auditors and for control in specific functions, such as financial reporting and legal compliance?
• Does the fund manager have appropriate methods for planning, executing and controlling the fund’s day-to-day operations, including:
  — key statistics, relationships or other information used by the fund manager to control or evaluate the investment funds and the servicing organizations;
  — a formal and effective application system development and maintenance process at each of the servicing agents;
  — speed with which recommendations of internal and external auditors are addressed;
  — whether there is an internal audit function with a clearly defined approach;
  — whether control policies are constantly improved as a result of management or audit monitoring;
  — whether there are different control standards in place in different countries, locations, departments or divisions and the implications for the organization as a whole?

D. Monitoring
• How are major risks, opportunities and related control objectives monitored?
• How is the segregation of incompatible duties monitored and enforced?
• How does the fund manager identify and respond to unusual situations?
• Does the fund manager’s board of directors direct internal auditors or engage external auditors to provide independent assurance about the fund manager’s assessments of control?
• Does the fund manager refer conflicts of interest and its proposed methods of managing those conflicts to the IRC for review?
• Does the fund manager take the IRC’s recommendations into account when making its decisions?

The publication Guidance for Directors, issued by the CICA Criteria of Control Committee (changed to the Risk Management and Governance Board some years ago) sets out a broad understanding of control that is consistent with a board of directors’ responsibility for overseeing the organization’s activities. It notes that many boards assign overview of financial reporting and accounting control to the audit committee. The document suggests that the board can strengthen its independence by assigning to an audit committee duties for the review of the annual and interim financial statements and internal and external audit. The board would also need to be satisfied that it, or the audit committee, has a clear understanding with the auditors as to what information and assurance they are to provide and that such information or assurance has been received. Where
there is no statutory requirement for an audit, the board
would consider whether auditors should be engaged and
for what purposes.

The *CICA Handbook – Assurance* recommends (para-
graph 5751.17) that, “If the auditor has identified a mis-
statement resulting from a non-trivial error, the auditor
should consider the need to report it to the audit com-
mittee or equivalent, whether or not the error has been
corrected.” In addition, the *CICA Handbook* requires
(paragraph 5136.28) that, “When the auditor has
obtained evidence that indicates an illegal or possibly
illegal act, other than one considered inconsequential,
may have occurred, the auditor should ensure the audit
committee or equivalent and appropriate levels of man-
agement are informed.” Further guidance to auditors is
provided in *CICA Handbook* Section 5751, “Communi-
cations with Those Having Oversight Responsibility for
the Financial Reporting Process.”

Under NI 81-107, the IRC of a mutual fund must
approve any change in auditors proposed by the fund
manager, which is somewhat similar to a corporate audit
committee’s mandate to recommend the nomination of
external auditors.

Assessing the role of those having oversight
responsibility for the financial reporting process
The Study Group believes that governance is enhanced
when the board of the fund manager (or one of its
committees) takes responsibility for oversight of the
financial reporting process, with specifically defined
roles and responsibilities. As a minimum, the duties of
an oversight body should include:

- review of the fund’s financial reporting activities;
- oversight responsibility for management reporting
  on internal control;
- direct communications with the internal and exter-
  nal auditors.

Control measures for assessing the oversight of the
financial reporting process are presented in Exhibit 3.8.

### Exhibit 3.8

**Control Measures for Oversight of the Financial Reporting Process**

<table>
<thead>
<tr>
<th>A. Establishment</th>
<th>• Does the board of the fund manager or an appropriate committee take responsibility for oversight of the financial reporting process?</th>
</tr>
</thead>
<tbody>
<tr>
<td>B. Independence</td>
<td>• Does the board, or an appropriate board committee, have any independent members?</td>
</tr>
</tbody>
</table>
| C. Duties and responsibilities | • Are the duties and responsibilities of the board (or one of its committees) clearly defined in the form of a written charter?  
  • Do the duties include a review of the investment funds’ financial reporting activities (for example, annual and interim financial statements), approval of any proposal to remove the auditors and/or to appoint new auditors and oversight responsibility for management reporting on internal control? | |
| D. Communications | • Does the board (or a committee) have direct communication channels with the internal and external auditors to discuss and review specific issues, as appropriate? |
| E. IRC Approvals | • Has the IRC approved any changes in auditors as required by NI 81-107? |

### Communications

*Communications* deals with the responsibility of a gov-
erning body to communicate information to and from
external parties, including investors.

A fund manager’s board of directors should explicitly
assume responsibility for a fund manager’s commu-
nications policy. The board is responsible, at law, for
approving certain accountability reports to investors in
the funds and other principal stakeholders. The annual
financial statements, management report of fund per-
formance and the prospectus and annual information
form usually form the primary accountability reports.
The board may also approve the annual report, interim
financial statements and nonfinancial accountability
reports of the investment funds.
The quality of disclosures to key stakeholders, and the fairness with which all stakeholders are treated, can significantly affect a fund manager’s reputation. Accordingly, the board will be interested in the effectiveness of control related to the appropriateness, completeness, accuracy and timeliness of such disclosures. The board will also be interested in the effectiveness of control related to any other disclosures that the board approves and to the compliance of other disclosures with laws and regulations. National Instrument 81-106 Investment Fund Continuous Disclosure provides further guidance for developing a communications policy for investment funds. NI 81-107 requires an IRC to report annually on prescribed items to investors.

Assessing communications

The Study Group believes that governance is enhanced when the fund manager assumes responsibility for a communications policy that encompasses approval of disclosures, external and internal communications and confidentiality.

Control measures for assessing communications are presented in Exhibit 3.9.

Exhibit 3.9

Control Measures for Assessing Communications

<table>
<thead>
<tr>
<th>A. Approval of disclosures</th>
<th>B. External communications</th>
<th>C. Internal communications</th>
<th>D. Confidentiality</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Does the fund manager understand what disclosures it must approve or review before issuance?</td>
<td>• Does the fund manager have adequate communications with significant stakeholder groups?</td>
<td>• Does the fund manager’s board receive information about internal communications?</td>
<td>• Are there procedures in place to maintain confidentiality of information provided to the board of the fund manager and to protect internal and external sources?</td>
</tr>
<tr>
<td>• Has the fund manager decided what disclosures it will approve or review?</td>
<td>• Does the fund manager safeguard the investment fund’s reputation through disclosures to key stakeholders that are appropriate, complete, accurate and timely?</td>
<td>• What is the degree of communication and interaction between the fund manager and the various servicing organizations?</td>
<td></td>
</tr>
<tr>
<td>• Are all such disclosures provided on a timely basis, with opportunity for review and discussion?</td>
<td>• Are disclosures in compliance with laws and regulations?</td>
<td>• Are there established review and approval procedures for changes in accounting and control systems?</td>
<td></td>
</tr>
<tr>
<td>• Does the fund manager’s board receive timely reports and recommendations from the committee(s) to which it has delegated responsibility for review of the fund’s accountability reports and disclosures?</td>
<td>• Is feedback received from investors or other principal stakeholders that should be factored into the fund manager’s decisions?</td>
<td>• Is there an effective system of communicating policies and procedures within and among organizations?</td>
<td></td>
</tr>
<tr>
<td>• Do the board and/or the audit committee have a clear understanding with the auditors as to the information and assurance they are to provide and is such information and assurance received?</td>
<td>• Are significant stakeholder interests reflected in the fund manager’s values, mission and vision?</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Has the fund manager’s board considered communicating its assessment of the effectiveness of governance and control processes to investors in the investment funds (or equivalent primary stakeholders) to which it is accountable?</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Does the IRC annual report to investors adequately comply with NI 81-107 and is the report posted on the fund manager’s website?</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Chapter 1 introduced the concept of an integrated risk/control framework separated into four broad areas – nature of business, governance, operations and compliance. Chapters 4, 5 and 6 address the third part of the Investment Fund Risk/Control Framework, which is reproduced below. This chapter examines investment fund operations regarding agency relationships and the valuation of investments.

### Investment Fund Risk / Control Framework

**Part 3 - Operations**

<table>
<thead>
<tr>
<th>Agency Relationships</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation of Investments</td>
</tr>
<tr>
<td>Fund Accounting and Reporting</td>
</tr>
<tr>
<td>Information Systems</td>
</tr>
</tbody>
</table>

For these two major components of the framework, the key risk elements are as follows:

- **Agency Relationships** which encompass the investment adviser, transfer agent, custodian and fund accounting and reporting (discussed in Chapter 5);
- **Valuation of Investments** which encompass basic methods of valuation, securities valued using publicly-traded available quotations, securities valued using other than publicly-traded available quotations, and special circumstances affecting the valuation of investments.

### AGENCY RELATIONSHIPS

Investment funds typically operate through service organizations or agents. Under a management agreement, the fund manager sponsors the fund, usually provides the initial seed capital, markets it to investors and is responsible for its day-to-day operations. The fund manager is responsible for administering all necessary services, facilities and personnel in connection with the fund’s activities. Certain minimum “operating” requirements are prescribed in the statutes and regulations applicable to mutual funds, fund managers, dealers and investment advisers.

A fund’s significant operational activities may be performed by its fund manager or contracted out, or a combination of both. As Exhibit 4.1 shows, the service organizations, functions or agents involved in carrying out the operations include:

- **Investment Adviser.** Investment advisers manage the investment portfolio, providing investment analysis and making decisions about how the fund’s assets are to be invested. An investment adviser may also choose to engage a sub-adviser to provide these services for some or all of an investment fund’s portfolio.
- **Transfer Agent.** The transfer agent maintains the records for investors, including transaction histories.
- **Custodian** (including securities lending). The custodian usually maintains custody of a fund’s investments and, possibly, acts as a lending agent for those investments.
- **Fund Accounting and Reporting.** These functions are generally handled by a group known collectively as “fund accounting.” Fund accounting maintains a fund’s general ledger, prepares financial statements and other related reporting as well as calculates the fund’s daily NAV. Fund accounting and reporting is discussed in Chapter 5 of this Research Report, with the exception of valuation of portfolio investments which is discussed in this chapter.
Although an agency relationship may exist for any of these functions, ultimate responsibility for the fund remains with the fund manager.\textsuperscript{16, 17}

**INVESTMENT ADVISER**

Securities regulators have special categories of registration for investment advisers.\textsuperscript{18} An entity making the investment decisions must be registered as an investment adviser with the securities regulators and meet proficiency, insurance and capital requirements.\textsuperscript{19} If the fund manager is also an adviser, the manager must be registered in both categories as proposed in NI 31-103.

**Investment Research and Analysis**

As part of the investment management process, the investment adviser (or sub-adviser) engages in research and analysis to determine what investments should be held in the portfolio, subject to the mandate of the fund and its investment objectives. This involves analysts gathering and analyzing data from various sources to identify investments that are attractive from the investment adviser’s perspective.

Professionally managed portfolios use two primary types of analysis: fundamental and quantitative. Fundamental analysis includes bottom-up analysis, focusing on the state of a company to predict future earnings, and top-down analysis, focusing on the expectations for an economy or sector of an economy. Quantitative analysis is more numerically focused, relying on financial models to identify attractive investments. Passively managed

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\textsuperscript{16} Section 116 of the *Securities Act* (Ontario) for example, requires fund managers to exercise the powers and discharge the duties of their office honestly, in good faith and in the best interests of the investment fund and to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances.

\textsuperscript{17} In September 2008, the compliance team of the Ontario Securities Commission (OSC) issued OSC Staff Notice 33-731 – 2008 Compliance Team Annual Report. One of the three significant deficiencies identified in the compliance reviews of fund managers was their oversight of service providers. About 36% of fund managers had significant deficiencies in this area. The OSC found inadequate procedures to ensure that service providers were performing their outsourced functions properly, fund managers had limited communication with service providers and there was a lack of evidence that fund managers were reviewing outsourced functions to ensure that service providers were fulfilling their duties.

\textsuperscript{18} Securities regulation defines an investment adviser as a person or company that provides investment advice or portfolio management services under a contract with an investment fund or with the fund manager of a fund.

\textsuperscript{19} NI 31-103 proposes enhanced capital requirements for investment advisers (see Chapter 7).
portfolios, such as those found in index investment funds, do not rely on any fundamental or quantitative analysis but, instead, hold investments in proportion to the fund’s stated benchmark index.

The investment adviser uses the resulting information to construct the portfolio. The adviser considers the relative attractiveness of the investments in the universe of investments covered by a fund’s investment objective, and incorporates risk considerations, for example, keeping a desired level of diversification (including considering correlation of returns between specific investments) and ensuring that sector or geographical weightings are appropriate for the desired level of risk for the portfolio. The fund’s cash holdings will also be a factor in determining its overall risk level. In addition to the investment objective, the fund’s portfolio must consider regulatory limits, prospectus limits and internal limits.

The foundation of an effective investment management program is the development and implementation of clearly defined policies, formally established in writing. These set out the fund’s investment management objectives and the parameters under which investment activities are to be undertaken and controlled. Each fund, therefore, needs to establish explicit and prudent investment management objectives governing:

- the extent to which the fund is willing to assume risk;
- areas of investment activities in which the fund is prepared to engage or is restricted from engaging, including the fund’s policy for acquiring investments of related parties;
- minimum quality and rate of return expectations for the fund’s investments;
- the selection of securities dealers and other counterparties with whom the fund is authorized to deal or is restricted from dealing with; and
- investment concentration and exposure limits.

Investment management objectives reflect a fund’s risk philosophy, codify investment criteria, establish the foundation for investment management strategies and provide the basis for monitoring portfolio characteristics and measuring portfolio performance. They also provide overall parameters for governing securities investment decisions by describing the broad purpose and goals of securities investments. Investment objectives assist in ensuring that investments are sound and prudent, and that the portfolio risk is acceptable given the expected return.

**Investment Operations**

After its initial construction, an investment fund’s portfolio will shift over time with changes in the investment adviser’s desired mix of investments, changes in the market value of the portfolio investments and changes in cash flows resulting from investor purchases and redemptions and net investment income. The investment adviser communicates the resulting trade orders to the trade desk, typically through a trade order management system. The trade desk will then interact with broker/dealers or alternative trading venues to place the trades for execution, seeking to achieve best execution. “Best execution” is generally considered to mean the most favourable combination of trade price, brokerage commission and other services, not merely the lowest cost execution possible. Once executed, a trade is communicated to the fund’s accounting and custody systems, for appropriate confirmation, recording and settlement.

Sound investment management requires that effective procedures be established and followed for the execution of portfolio investment transactions and the management/custody of investments. Effective procedures and controls ensure that investment activities comply with the investment fund’s policies and provide safeguards against potential losses by ensuring that there is no unauthorized exposure due to improper or uncontrolled investment activities.
Although the controls over investment activities will vary among investment funds depending on the nature and extent of their activities, the key elements of any investment management control program are well-defined guidelines governing organizational controls, procedural controls and monitoring controls.

Organizational controls ensure clear and effective segregation of duties among persons who:
- authorize, initiate or supervise investment activities;
- are responsible for operational functions such as the custody of investments, or arranging prompt and accurate settlement of transactions; and
- account for investment activities;

Procedural controls for portfolio investments ensure that:
- investments are properly recorded and accounted for;
- investment transactions are settled in a timely and accurate manner;
- investments are appropriately and fairly allocated among funds managed by the same fund manager;
- investments are appropriately safeguarded (including, where the fund uses the services of third-party depositories for investments, procedures to ensure that such depositories have established appropriate procedures to obtain and maintain possession or control of investments purchased on behalf of the fund);
- unauthorized investments activity is promptly identified and reported to management; and
- trade errors are identified quickly and escalated appropriately, adequately documented and resolved in a timely and fair manner.

Monitoring controls ensure that investment activities are monitored frequently against the fund’s policies and risk limits, excesses reported and corrective action taken, if necessary.

Objectives, Risks and Control Measures
The core objectives of the investment adviser function, together with corresponding risks of not meeting the objectives, are summarized in Exhibit 4.2.

TRANSFER AGENT
The transfer agent carries out all of the transactions and maintains all of the records for fund investors. Although, in certain cases, an investment fund’s transfer agent (or investor record keeping service) may be independent of the fund, often the fund manager or an affiliate performs these functions. Certain functions within the transfer agency area are subject to securities regulations, and many of the activities require unique comprehensive controls to be applied on a daily basis.

For closed-end funds, the transfer agent’s functions are similar to those for other public companies. For open-end funds, however, the transfer agent maintains all of the records, including transaction histories for each individual investor in the fund. These records include the number of units/shares outstanding, number of units/shares subscribed/redeemed and those not yet settled, dividends/distributions paid or reinvested, cash relating to investor transactions received and disbursed and tax filing records.

The transfer agent may also look after the customer service functions. Generally, the transfer agent (or the fund manager) answers investor queries or refers them to the appropriate party who can provide an answer. Ideally, Customer Relationship Management (CRM) systems are employed to provide a record of investor queries, complaints or common transactions requested, which can be summarized for senior fund manager staff for follow-up purposes. Such a log may be a useful source in identifying potential control or processing weaknesses within the transfer agent functions. Client complaints must be followed up in a specific manner if the fund manager is a member of the MFDA or IIROC, and CRM records can assist in the capture of this information.
Investor Record Keeping

**Processing of sales and redemptions**

Prior to processing a sale of units/shares, an investor must provide certain background information. This information is usually contained in the application form, which may include the investor’s name and address, bank information, load, withdrawal and income distribution (cash or reinvestment) options. The transfer agent may be responsible for ensuring that applications and orders are complete prior to processing.

Initially, processing involves the acceptance of an order, which entails obtaining all the documentation necessary to support the order, the payment for sales and ensuring the order complies with securities regulations. Often, securities regulations provide a specific time limit for accepting and processing an order; otherwise, the order must be cancelled. Once an order is complete, it is processed into the investor’s account and the related cash is transferred to the fund for a sale or paid to the investor either directly or via a third party, such as a broker-dealer, for redemption. Total sales, redemptions and dividends/distributions are reported to the fund accounting agent daily so that the equity activity can be recorded in the general ledger for inclusion in the calculation of the NAV.

Sales and redemptions are received through various distribution networks and communication media. An open-end fund may use independent agents, broker-dealers, financial institution branches or internal salespersons, or a combination of them, to create and maintain relations with investors. Because a closed-end fund does not continuously issue additional units/shares and the trades are performed on the open market, standard brokerage trading processes are usually followed.

Orders for either sales or redemptions are usually processed by mail, telephone, electronic transfer or directly at a financial institution branch. The method followed will depend on the distribution channel(s) a fund uses. Often, orders are processed at a broker-dealer or financial institution branch and transmitted electronically to the transfer agent. When an order is received, the transfer agent obtains unit/share pricing information from the

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20 The use of hedging techniques is one means of managing and controlling market risk. Many different financial instruments can be used for hedging purposes; the more common are derivative financial instruments, such as futures contracts, options, swaps and market price indices.

21 FundServ provides services to the Canadian investment fund industry. It develops transaction standards industry-wide.
fund accounting agent, based on the fund’s NAV per security next determined after receipt of the order. The unit/share price is then used to calculate the number of unit/share sales or redemptions. Although the units/shares are generally retained on a book basis, in some cases, certificates are requested and issued.

Processing dividends/distributions
Generally, an investor may choose to receive dividends/distributions in cash or in additional units/shares of the fund. Usually, investors state their preference in their initial application. The fund accounting agent transmits dividend/distribution information (e.g., rate, dates), as approved by the fund’s governing body, to the transfer agent for processing.

The transfer agent is usually responsible for processing and paying dividends/distributions allocated by the fund to investors. Dividend/distribution information is important because the fund may have to send an annual taxation form to investors outlining the information required for them to complete their tax returns. The information necessary to complete these forms is derived from the dividends/distributions allocated to each investor. Usually, the transfer agent issues the taxation forms on behalf of the fund.

Transaction errors
Despite the best efforts of transfer agents to process transactions accurately, errors may inevitably occur. It is important that errors are identified in a timely manner and corrected appropriately, ensuring that neither the investors nor the funds are negatively affected.  

Maintaining tax filing records
A fund’s specific tax implications depend on its legal form (for example, whether the fund is operating as a trust, a partnership or a corporation). Typically, a fund distributes to investors substantially all of its taxable income earned during the year, although certain types of income cannot be distributed by mutual fund corporations. Generally, for trusts, this distribution needs to be paid or payable on or before the last business day of the calendar year to avoid taxation at the fund level. There is a risk of an unrecorded tax liability at year end where distributions during the year do not equal the fund’s net income.

A review of reconciliations between reported earnings and distributions assists in identifying a potential unrecorded tax liability in the fund. If the fund is a corporation, it is usually subject to the same taxes as any other corporation unless it is eligible for special exemptions. A fund will often have investors who are not resident for tax purposes in the jurisdiction where the fund is located. When dividends/distributions are made to these investors, the taxation authorities usually require the fund to withhold taxes and remit them on behalf of the investors. If this is not done correctly, the fund can incur a tax liability. As taxes are specific to each jurisdiction, it is important to ensure that the risks have been properly identified.

Trust accounting
When purchasing or selling units/shares in an investment fund, an investor either has to pay for the investment or is owed the proceeds of disposition. In the investment fund industry, there is usually a period of time where such monies are temporarily held by an intermediary, usually the transfer agent, prior to being transferred. Often, to protect investors from loss, the treatment of these monies is regulated. The regulations may specify the period in which monies should be cleared, the segregation of the monies (so they are

22 IFIC’s Phase 2: Report of the Error Corrections Working Group (revised May 2003) provides guidance in the resolution of transaction processing or trading errors.

23 A liability for withholding taxes may extend to the trustee in a trust situation (that is, taxation authorities can seek payment of tax from the fund and the trustee). Nonetheless, declarations of trust or investment management agreements (for any type of fund) may include clauses that indemnify the trustee for errors or other acts of the fund that result in a tax liability.
not commingled with the fund manager’s, distributor’s or dealer’s monies) into a separate bank account (for example, trust account) and the treatment of interest earned in the bank account (compliance requirements with respect to trust accounts are discussed in Chapter 7 this Research Report).

The fund manager is usually responsible for the trust accounts and, therefore, could be liable for any losses resulting from incorrect transactions or a misappropriation of funds. Hence, trust accounts should have controls similar to bank accounts. In particular, monies in a trust account should be reconciled to the sales/redemptions sub-ledger to ensure that all monies correspond with either sales payments into the fund or redemption payments out of the fund.

**Objectives, Risks and Control Measures**

The core objectives of the transfer agent, together with corresponding risks of not meeting the objectives, are summarized in Exhibit 4.3.

Specific objectives include the following:

1. **Unit/share sales and redemptions**

2. **Investor equity**

<table>
<thead>
<tr>
<th>Core Control Objectives</th>
<th>Corresponding Risks</th>
</tr>
</thead>
</table>
| Complete and accurate recording of the number of outstanding units/shares | • The number of units outstanding per the fund accounting system does not reconcile with units held by investors per the transfer agency system.  
• Cut off procedures for purchases and redemptions do not meet stated fund rules and regulations. |
| Complete and accurate recording of receivables for units/shares sold and payables for units/shares redeemed | • Purchases and redemptions are not calculated according to the applicable NAV per security.  
• Purchases and redemptions received in good order are not completely and accurately recorded, accumulated, and reported in the proper period. |
| Complete and accurate determination and reporting of distributions from investment income, net realized gains from securities transactions and capital, and their investments | • The fund accounting system does not transmit accurately the dividends/distribution information (rate, dates) to the transfer agent for processing as approved by the fund’s governing body.  
• Distribution amounts are not accurately calculated and processed.  
• The distribution to the investors was not performed in accordance with investors’ agreement (receive in cash or additional units/shares). |
| Complete, accurate and timely recordkeeping for individual investor accounts | • Investor transactions not in good order are accepted and recorded.  
• Investor transactions are not processed on time according to the fund’s offering documents.  
• Non-financial changes to investor data may be inappropriate, allowing unauthorized transactions. |
| Complete and accurate recording of cash in trust accounts | • Separate trust accounts for deposit of investor cash are not appropriately set-up.  
• Cash from investors is com mingled with fund manager cash accounts. |
3. Compliance

- is met with respect to the requirements of the applicable securities regulators, taxation authorities and the fund’s prospectus/offering memoranda;
- is maintained through a strong control environment and is in compliance with the requirements of the applicable securities regulators; and,
- ensures that errors are identified in a timely manner and resolved in accordance with industry practice.

The Study Group identified a number of factors or conditions that may influence the assessment of risk associated with transfer agency functions, including the following:

- dormant or nominee accounts may make the fund more susceptible to fraudulent activities or the manipulation of investor records;
- unreconciled trust accounts;
- poor communication among the fund manager, transfer agent, distributor and fund accounting agent;
- volume of non-financial updates to investor accounts;
- complexity and extensiveness of the distribution network for sales and redemptions;
- complexity of product and the unit structures associated with varied fees.

Other factors may also represent areas of increased risk, for example:

- significant increase or decrease in the size of the fund compared to prior year;
- significant fluctuations in NAV per security during the period, which increase the potential effect of erroneously processed transactions;
- significant or rapid increase in the volume of sales or redemptions;
- poor communication among the fund manager, transfer agent, distributor and fund accounting agent, resulting in improper or unrecorded transactions;
- change of investor servicing agent or transfer agent or reallocation of duties among agents;
- the fund manager has limited professional expertise;
- conversion of transfer agent systems (for example, conversion from outside service bureau to in-house system for transfer agency functions or vice versa);
- high volume of outstanding sales and redemptions at year end;
- significant amounts of past due receivables or payables for capital transactions;
- evidence of noncompliance with investor related regulatory requirements;
- high volume of non-financial updates to investor accounts;
- unusual changes in special purpose reports (i.e., CICA Handbook Section 5970 reports) such as scope changes;
- significant volume of investor complaints about service quality, including accuracy of either investor information or sales/redemptions.

As well, prior experience of errors may indicate areas of increased risk, for example:

- errors in calculating sales and redemptions in prior year;
- cutoff errors for outstanding sales and redemptions;
- errors in the calculation of tax distributions or production of tax reporting to investors or investor statements;
- prior year history of noncompliance with regulatory requirements.

In the Study Group’s view, control measures over the processing of transactions are vital to ensure the accuracy of investor information. Although some controls are designed to ensure that funds comply with
securities regulations, they also provide assurance on the accurate and timely processing of transactions.

Control measures for assessing the appropriateness of transfer agency activities are presented in Exhibit 4.4.

Key control measures include:
- regular reconciliation of the transfer agent’s records to the fund’s general ledger;
- annual review of special purpose reporting, such as reports issued under Section 5970 of the CICA Handbook - Assurance where transfer agency services are outsourced, combined with periodic management reviews of services during the year;
- periodic client confirmation procedures, such as mailing trade slips confirming transactions and periodic statements to investors;
- controls over transactions in and/or changes to inactive accounts;
- error resolution policies and procedures; and
- trade monitoring and compliance activities designed to identify large dollar trades, backdated trades, market timing activity or other unusual trade activity.

Regular reconciliation of the transfer agent’s records to the fund’s general ledger will ensure that all transactions are properly recorded in the appropriate period. Confirmation of trades and periodic investor statements provide investors with the opportunity to review transactions for accuracy. Inactive accounts may present the opportunity for unauthorized activities in the account, potentially leading to a misappropriation of funds; often, any activity processed in these accounts is carefully scrutinized prior to being authorized.

Exhibit 4.4

Control Measures for Assessing Transfer Agent Activities

<table>
<thead>
<tr>
<th>A. Fund manager reviews</th>
<th>Consider whether the fund manager reviews the reasonableness of the daily NAV calculations.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Does the fund manager review the monthly summaries of sales/redemptions for reasonableness of the relationship between units/shares and amounts and transaction volumes?</td>
</tr>
<tr>
<td></td>
<td>Does the fund manager review the financial statements for reasonableness of units/shares outstanding and dividends/distributions paid or payable?</td>
</tr>
<tr>
<td></td>
<td>Has the fund manager approved the data (rates, dates, etc.) used to calculate dividends/distributions?</td>
</tr>
<tr>
<td></td>
<td>Has an appropriate official reviewed and approved the classification of dividends/distributions among various types of income, capital gains and return of capital?</td>
</tr>
<tr>
<td></td>
<td>Does the fund manager review and approve the issuance of stock certificates?</td>
</tr>
<tr>
<td></td>
<td>Does the fund manager obtain, review and decide whether to rely on a service provider’s auditor’s report (such as that issued under Section 5970 of the CICA Handbook - Assurance)?</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>B. Reconciliations</th>
<th>Consider whether the fund manager or principal distributor has reconciled the trust bank account through which sales and redemptions flow to the investor servicing ledger on a timely basis.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Does an appropriate official regularly prepare, review and approve reconciliations of sales and redemption listings to cash records?</td>
</tr>
<tr>
<td></td>
<td>Are regular reconciliations prepared of the equity ledger (both units and value) per the transfer agent’s records to the fund’s general ledger? Does an appropriate official review and approve them?</td>
</tr>
<tr>
<td></td>
<td>Are reconciliations prepared of the dividends/distributions listing to the fund’s general ledger? Does an appropriate official review and approve them?</td>
</tr>
<tr>
<td></td>
<td>Is interest earned in the trust accounts properly allocated to the funds in a timely manner?</td>
</tr>
</tbody>
</table>

| C. Segregation of duties | Consider whether there is adequate segregation of duties. Is the maintenance of investor records segregated from the cash receipts and payment processes? |

<table>
<thead>
<tr>
<th>D. Confirmations</th>
<th>Consider whether sales and redemption transactions produce a confirmation slip (which includes fund designation, number of units/shares, unit/share price and trade date) that is sent to investor.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Are account statements sent periodically to every investor? Are discrepancies followed up outside the accounting department?</td>
</tr>
<tr>
<td></td>
<td>Does the customer services department maintain a log of customer queries/complaints and report them to senior fund manager staff for review and follow up?</td>
</tr>
</tbody>
</table>

| E. Compliance | Consider whether the fund manager is aware of the regulatory requirements for sales and redemptions and ensures that these requirements are met. Does the fund manager review reports that track compliance with the various regulations and follow up on violations on a timely basis? |

When a fund uses a service organization, such as an outside transfer agent, sub-transfer agent or recordkeeping
agent, transactions that affect the fund’s financial statements are subject to policies and procedures that are, at least in part, physically and operationally separate from the fund. The relationship of the policies and procedures of the service organization to those of the fund depends primarily on the nature of the services provided. For example, when those services are limited to recording fund transactions and processing related data, and the fund retains responsibility for authorizing transactions and maintaining related accountability, there will be a high degree of interaction between the service organization’s policies and procedures and those of the fund. In such circumstances, the fund should implement effective control activities for those transactions.

CUSTODIAN

Custody
The cash and investments comprising an investment fund’s portfolio are usually held by an authorized custodian. The custodian may be an independent third party or directly related to the fund manager, but is usually a financial institution, such as a bank or a trust company or, in certain circumstances, a prime broker. The custodian usually performs several functions, such as maintaining custody of the fund’s investments, collecting income, paying expenses, settling investment transactions and receiving and disbursing cash from or to the transfer agent for capital transactions.

Securities regulations prescribe the type of entity eligible for fund custodianship.\(^{24}\) Securities regulations impose an objective standard of care on custodians of the assets held by mutual funds; custodianship must be carried out by a third-party custodian and is regulated. The choice of custodian is very important because it controls the majority of a fund’s assets.

When a third-party custodian is used, it is good practice for the fund’s governing body to annually approve a custodial agreement that addresses:

- the physical and book segregation of investments held by the custodian;
- the restriction on the custodian to assign, hypothecate, pledge or dispose of investments or other assets of the fund except when acting on the instructions of the fund; and
- the immunity of the fund’s investments to liens or encumbrances committed by the custodian.

To assess overall risk associated with a custodian relationship, consideration should be given to:

- the reputation of the custodian and any involvement in questionable acts;
- the level of regulation over the custodian’s operations;
- the custodian’s net assets/capital base and whether they are sufficient to cover a loss;
- the custodian’s insurance coverage;
- any errors identified in reconciliations between the custodian records and those of the fund;
- any special purpose report (such as under Section 5970 of the CICA Handbook – Assurance).

When some of an investment fund’s investments are held at in-house vaults, controls should be in place to ensure that the assets are properly safeguarded.

Securities Lending
The investments comprising an investment fund’s portfolio may be lent out as part of a securities lending program. Although, typically, the custodian handles such arrangements, an independent third party or someone directly related to the fund manager may look after them.\(^{25}\) The securities lending agent performs several functions, such as fixing remuneration for the lending of the investments, reviewing and analyzing

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\(^{24}\) NI 81-102, Part 6, deals with the “Custodianship of Portfolio Assets.” It defines “custodian” as the institution appointed by a mutual fund to act as custodian of the portfolio assets of the mutual fund.

\(^{25}\) For mutual funds governed by NI 81-102, securities regulations require that the securities lending agent be the custodian.
credit worthiness of counter-parties, securing adequate and acceptable collateral and allocating program fees/revenues to the fund.

The lending out of a fund’s investments is not without certain inherent risks. Securities regulations impose restrictions and conditions on fund managers whose funds choose to participate in the lending of securities.

When investments are lent, the fund will hold collateral of an amount greater than the market value of those investments. Typically, the amount of collateral is equal to or greater than 102% of the investments on loan. As well, securities lending agents may offer to indemnify the funds for any losses that may be realized through the lending of investments, although this will normally result in greater fees paid to the lending agent.

To assess overall risk associated with securities lending, the following should be considered:
• the reputation of the agent and any involvement in questionable acts;
• the level of regulation over the agent’s operations;
• the ability and willingness of the agent to recall investments on notice by the fund manager;
• the agent’s insurance coverage;
• the quality and sufficiency of the collateral received and the investment thereof;
• the quality and timeliness of reporting by the agent on lending program value to the funds;
• the creditworthiness of the counterparty.

Objectives, Risks and Control Measures
The core objectives of the custodian function, together with corresponding risks of not meeting the objectives, are summarized in Exhibit 4.5.

VALUATION OF INVESTMENTS
One of the primary objectives of an investment fund is to maximize investment returns in relation to the investment objectives and policies. Portfolio investments produce income from dividends, interest and changes in the values of investments while they are owned by the fund.

Exhibit 4.5

<table>
<thead>
<tr>
<th>Core Control Objectives</th>
<th>Corresponding Risks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintain custody of cash and securities and records of cash and securities.</td>
<td>• Securities are not protected from loss, misappropriation and unauthorized use. • There is no adequate segregation of duties within the custody functions. • The custodian does not have an adequate financial situation or insurance coverage to ensure it can meet service obligations. • Changes to significant standing data (e.g., bank transfer instructions and authorized signatories) are not authorized and not correctly recorded on a timely basis.</td>
</tr>
<tr>
<td>Investment income is distributed accurately and completely.</td>
<td>• Dividend and interest income are not collected and not distributed accurately and timely.</td>
</tr>
<tr>
<td>Trades and corporate actions, purchases and sales transactions are recorded completely and accurately.</td>
<td>• Trades and corporate actions are not settled, recorded and reported completely, accurately and timely in accordance with client agreements.</td>
</tr>
<tr>
<td>Cash-related activities are executed in accordance with client agreements and trade instructions.</td>
<td>• Cash receipts and disbursements are not authorized, processed and recorded completely, accurately and timely.</td>
</tr>
<tr>
<td>Securities lending services are in accordance with client agreements.</td>
<td>• Lender and borrower participation is not authorized. • Collateral is inadequate. • Collateral is not invested in accordance with the lender agreement and income is not calculated and distributed accurately and on a timely basis. • The counterparty is not creditworthy.</td>
</tr>
</tbody>
</table>
In many funds, the portfolio values and changes in those values have a much greater impact on the fund’s performance than does the investment income earned. Historically, many funds have invested primarily in listed investments where valuation and accounting were readily determined. However, the types of products investment funds offer are continually expanding, investment strategies are becoming more sophisticated and the investment vehicles themselves are increasingly complex. These trends create an environment of higher valuation risk for either a specific fund or an entire group of funds.

To address this higher risk, it is important to consider all events and circumstances that may affect the valuation of investments. It is essential to understand what is done (practice), why it is done (policy), who is doing it (individuals), when it is done (timing), where it is done (external/in-house) and how it is done (techniques).

The amount of guidance as to how an investment fund should value its investments and determine its NAV per security has grown over the last decade. Guidance on various aspects of investment valuation is available in the following sources:

- NI 81-106;
- 2009 CICA Research Report Financial Reporting by Investment Funds;
- 1997 Investment Company Institute (ICI), Valuation and Liquidity Issues for Mutual Funds;
- 1998 Executive Summary of IFIC’s Portfolio Pricing Survey;
- 2002 IFIC bulletin Fair Valuing Portfolio Securities;
- 2004 IFIC document Guidance on Portfolio Pricing;
- CICA Handbook – Accounting Section 3855, FASB FAS 157 and IASB IAS 39;
- 2008 AICPA Audit and Accounting Guide Investment Companies.

For years beginning on or after October 1, 2006, investment funds generally value investments in two different ways, at least for financial period ends. For financial statement purposes, the value of publicly-traded investments must be based primarily on “bid” for long and “ask” for shorts as required by Section 3855 of the CICA Handbook. For the purposes of transacting with investors, the valuation of investments may be based on methods other than bid, such as “last trade.” These other valuation methodologies are used to determine the NAV per security, which is the focus of the remainder of this chapter. The terms and conditions relating to the NAV per security form the basis for the commercial bargain between an investment fund and its investors, and are usually found in the fund’s constating documents and Annual Information Form.

Exhibit 4.4 highlights issues related to various types of investments. It shows the basic methods used for valuing various types of investments for purposes of determining the NAV per security. It also shows that, in certain circumstances, it may be appropriate or necessary to estimate the fair value of investments in good faith.

**Basic Methods of Valuation**

For purposes of determining the NAV per security, investment funds value their portfolio at the time of day and frequency determined by the fund manager, trustee or governing body in accordance with the fund’s constating documents. These are commonly referred to as “valuation dates.” Most investment funds (including open-end mutual funds) value their investments every business day, although some may do this less frequently.26

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26 For example, NI 81-102 (Part 13) states that, if a mutual fund invests in, uses or holds specified derivatives, the NAV must be calculated no less frequently than once every business day.
The valuations are used for determining the fund’s NAV per security. In turn, the NAV per security is crucial to all investors because it provides an ongoing basis for effecting sale and redemption transactions at appropriate prices. Furthermore, Canadian securities regulations require the use of “forward pricing” based on the NAV per security of the fund next determined after receipt of an order (this matter is discussed elsewhere in this Research Report).

Regardless of the timing and frequency of valuation, certain valuation methods are considered generally acceptable. There are basic methods of valuing listed and over-the-counter investments, representing broad principles of valuation for certain types or classes of investments. It is important that the basic methods of valuing investments are used consistently in practice and can be audited by conventional means.27

The value of an investment may be measured in a variety of ways, depending on the nature of the instrument and how it is traded. Value is the market price or fair value of the investment on each valuation date. To determine an investment’s value, it is essential to ascertain whether

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27 Section 97 of the Regulations under the Ontario Securities Act covers the valuation of securities at market value.
the investment is listed and whether the investment was traded on the valuation date. If the investment was traded, the quoted market price on the valuation date will generally provide the best evidence of value. Market price is normally the last reported selling price for an investment. If the investment was not traded or the selling price was not reported, market price would normally be based on recent bid and ask quotes.

Fair value refers to an estimated value determined in good faith for investments and other financial instruments that have no readily available market price. This process is often referred to as “fair value pricing.” Alternative methods of valuation may need to be developed and they may require different control measures to address different risks.

Regardless of how investments are valued, fund managers need to assess whether the resulting values are appropriate. As a result, it is not sufficient for a fund manager to simply rely on the valuation of investments resulting from a rigid application of the valuation principles.

Securities Valued Using Publicly Traded Available Quotations

Ordinarily, valuing investments traded in an active market is not difficult, because quotations of completed transactions or of bid and ask prices are available daily. This applies for both listed and unlisted investments. In an active market, transactions for the security occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

An investment traded on the valuation date generally is valued at the last quoted sales price. Certain exchanges may not provide a last sales price but, rather, some other data such as official closing price; the appropriateness of using that price should be considered. An investment listed on more than one securities exchange should be valued at the last quoted sales price at the time of valuation on the exchange on which the investment is principally traded. If the investment was not sold on that exchange on the valuation date, it might be appropriate to value the investment at the last quoted sales price on another exchange on which it was sold on the valuation date.

Investments not traded on the valuation date, for which published closing bid and ask prices are available, should be valued within the range of the closing bid and ask prices. As a general policy, some funds use the bid price, some use the mean of the bid and ask prices and some use a valuation within the range considered to best represent value in the circumstances. Each of those policies is generally acceptable if applied consistently. Normally, the ask price alone is not acceptable. If only a bid price or an ask price is available for an investment on the valuation date, or if the spread between the bid and ask price is substantial on that date, quotations for several days should be reviewed.

Securities Valued Using Information Other than Publicly Available Quotations from Trades

If an investment trades infrequently or in low volumes, or if some events have affected its value since the last trade, the reliability of market quotations should be considered. If market quotations for the investment are deemed not reliable, an estimate of value, as determined

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28 Under the US Financial Accounting Standards Board (FASB), Financial Accounting Statement No. 157 (FAS 157), inputs to valuations are categorized as Level 1, Level 2 and Level 3 in a hierarchy designed to increase consistency and comparability in fair value measurements and related disclosures. Level 1 inputs, the highest in the hierarchy, are observable quoted prices. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable, either directly or indirectly, while Level 3 inputs are unobservable. Securities that are valued at the last quoted sales price or within the range of closing ask and bid prices are considered to be valued using Level 1 inputs.
in good faith by the fund manager, trustee or board of directors, should be used.\textsuperscript{29}

The following discusses considerations for valuing investments in good faith and considers special circumstances that may arise from time to time.

If market quotations are not available or are considered unreliable, it may be necessary to estimate the fair value of investments. The objective of the estimating procedures is to state the investments at the amount the investment fund could reasonably expect to receive for them in a current sale, although the fund may not intend to sell them. The term \textit{current sale} means realization in an orderly disposition over a reasonable period.

There is no single method for determining fair value in good faith because fair value depends on the facts and circumstances of each individual case. Given the judgment required, the aggregate of investments valued in good faith, when significant, should be separately disclosed in a note to the financial statements. Furthermore, an investment fund should disclose, in the significant accounting policies note to the financial statements, the type(s) of investments whose values have been estimated in good faith and the method(s) of valuation.

All relevant factors should be considered in selecting the method of estimating the fair value of each type of investment or package of investments. The fund manager, trustee or governing body should be satisfied that all relevant factors have been considered and that the method used to estimate value is reasonable. The information considered and the basis for the decision should be documented and the supporting data should be retained. Individuals may be appointed to assist in the estimating process and to make the necessary calculations.

The following lists various factors that merit ongoing consideration (although, in certain circumstances and in the short term, some of these may not be readily available):

- financial standing of the issuer;
- business and financial plan of the issuer;
- cost at date of purchase;
- size of position held and the liquidity of the market;
- contractual restrictions on disposition;
- pending public offering with respect to the investment;
- pending reorganization activity affecting the investment (such as merger proposals, tender offers, debt restructurings and conversions);
- reported prices and extent of public trading in similar investments of the issuer or comparable companies;
- ability of the issuer to obtain needed financing;
- changes in the economic conditions affecting the issuer;
- a recent purchase or sale of similar investments;
- pricing by other dealers of similar investments;
- financial statements of the issuer;
- accounting, reporting and auditing framework in the country of the reporting issuer.

A variety of methods may be used in determining the value of an investment. These methods include analogy to reliable quotations of similar investments, pricing models, matrix pricing or other formula-based pricing methods. These methodologies incorporate factors for which published market data may be available. For instance, the mathematical technique known as matrix pricing may be used to determine values based on market data available with respect to the issue and similar issues

\textsuperscript{29} Under FAS 157, securities that are valued by way of an estimate depend on either Level 2 or Level 3 inputs. An example of a Level 2 input is a quoted price for a similar security in an active market. Level 3 inputs necessarily reflect the investment fund’s own assumptions, and would rarely be utilized in valuing securities for open-ended investment funds but would more commonly be used in valuing less liquid securities, for instance, private placements.
without exclusive reliance on issuer-specific quoted market prices.

Valuation methods may also be based on:
• a multiple of earnings;
• a discount (or premium) from market, of a similar, freely traded investment;
• a yield to maturity with respect to debt issues; or
• a combination of these and other methods.

In addition, other factors should be considered for derivatives and other financial instruments, such as current and future market prices, interest rates, foreign exchange rates, and equity or commodity prices, the expected rates of change in these market factors (volatility) and the term to maturity. The fund manager, trustee or governing body should review the appropriateness of such methods to become satisfied that the resulting valuations are reasonable.

Special Circumstances Affecting the Valuation of Investments
Based on regulatory requirements or other considerations, fund valuation procedures may specify pricing criteria or tests for particular types of investments, funds or transactions. Issues related to investments that have halted trading, pricing of foreign securities, foreign government actions, illiquid investments, money market investments, early market closings and foreign exchange rates are discussed below.

Investments that have halted trading
Situations may arise in which an investment’s last trade clearly does not represent current value, for example, in a long-term halt of trading or where a company is releasing important news that requires a short-term trading halt. In either case, there is a need to consider whether it is appropriate to fair value the investment in determining the investment fund’s NAV per security, as described in the previous section. At present, current practice varies considerably in both the valuation methods used and the degree of formalization of policies.

Timeliness is very important in assessing the factors suggested by these sources, given the need to process investor transactions on a daily basis. It may be crucial to:
• consult with both internal and external research analysts who specialize in stocks in the same sector as the investment being considered;
• attempt to obtain indicative broker bids;
• hold discussions with other investment fund companies;
• identify the reasons for halted trading and compare to similar situations.30

Judgment is also important in determining the fair value of investments because the circumstances of each situation must be carefully considered. Accordingly, investment funds should be prepared for these situations and have documented policies and procedures in place to address the following questions:
• Who should be involved in determining the fair value (for example, trading, legal and fund accounting might be involved, among others)?
• What standard steps should be taken to determine fair value?
• How is the investment fund’s governing body involved?
• How should the determination of fair value be documented?

Foreign investments
Investments issued by foreign companies raise some unique considerations not typically associated with investments issued by domestic companies. For example,

30 For instance, a company may indicate that it will likely be restating prior periods’ earnings; a number of other companies may have gone through similar problems and the impact on the share price of those companies can be examined in an effort to determine what the impact on the shares might be.
investments in certain foreign countries may be exposed to expropriation or confiscatory taxation, limitations on the removal of funds or other assets, political or social instability or adverse diplomatic developments. Individual foreign economies may differ from the economy of Canada in growth of gross national products, rates of inflation, capital reinvestments, resource self-sufficiency and balance-of-payments positions. As a result, investments of many foreign companies may be less liquid and their prices more volatile.

Foreign investments should be valued at current value by translating their foreign currency denominated value into Canadian dollars using current exchange rates. The basis for valuing foreign investments should be the same as the basis for valuing domestic investments. Often, foreign investments are traded in markets that close at different hours than Canadian markets. Fund valuation procedures provide that such investments normally will be valued at their most recent closing price on the principal exchange, even if the close of that exchange is earlier than the time of the fund’s NAV per security calculation. If an event likely to materially affect the value of a portfolio investment occurs after the foreign market has closed (but before the calculation of the fund NAV per security), it may be necessary to determine the fair value of the investment in light of that event.

Investment fund valuation procedures often provide for consideration of whether closing prices need to be adjusted to reflect developments that occur after the principal market(s) on which the fund’s investments trade closes but before the time of NAV per security calculation. The procedures may establish a process for determining when circumstances warrant making such an adjustment and provide specific criteria for establishing the fair value of the investment (fair value in such circumstances may be based on the opening price on the foreign exchange at which trading in the investment next begins, although this is too late for funds that determine their NAV per security on a daily basis).

The reason why some investment funds determine the fair value of all investments in a foreign market, rather than utilize last trades, is no different than the reason why the last trade is not used for companies announcing significant news while trading is halted. If a fund’s NAV per security does not reflect the values as of the time of pricing, there is an opportunity for dilution and, thus, unfairness to investors. Determining the NAV per security based on dated information raises many of the same issues as “backward pricing” which, as previously noted, is prohibited by law.31

To prevent potential fund dilution and unfairness to investors, the value of foreign investments used in determining a fund’s NAV per security may take into account all information available at the time of that determination. Since the local market has closed, other relevant sources of information must be examined to arrive at an appropriate price for each investment, for example:

- American depository receipts (ADRs);
- Global depository receipts (GDRs);
- index futures;
- closed-end country funds;
- other traded investments, such as exchange-traded funds that derive their value from either specific foreign investments or baskets of foreign investments;
- indicative bids received from brokers;

31 For example, in October 1997, international markets experienced severe volatility. A number of funds utilized fair value pricing in valuing shares of Asian companies, while many others did not. This generated a great deal of scrutiny (and many complaints from investors who were trying to take advantage of market swings). In response, the SEC undertook a review of the practice. This review indicated that mutual fund groups using fair value pricing methods to price their Asian shares after the October market plunge better protected investors from speculators than did funds using conventional pricing because investors experienced less dilution than funds that relied on market quotes in valuing the securities.
• consultations with research analysts who specialize in foreign markets.

Clearly, procedures should be designed to facilitate consistent application of the relevant criteria, and may require documentation of the course of action taken (even where a determination is made not to adjust the closing price). In the absence of specific criteria for making the adjustment, the fund’s governing body should review any adjusted price.

Third party services may be used to assist in determining the appropriate fair valuations of foreign investments. Such services provide a daily pricing feed that adjusts the value of foreign investments from last trade based on pre-set criteria. Alternatively, the pricing agent may use in-house methodologies.

**Foreign government actions**

As noted above, investments in certain foreign countries may not only be exposed to market risk, but also security markets may be structured differently for foreign versus local investors. For example, there may be restrictions on nonresident companies owning more than a fixed percentage of certain companies (that is, buying “foreign” versus “local” shares), or temporary or longer-term limitations may be imposed on the removal of funds or other assets. Investment funds need to implement procedures to ensure that they can deal with such circumstances using a consistent methodology.

Examples of such procedures include:
• tracking the premium paid for foreign registered shares over the local shares and applying the premium in valuing the portfolio holdings on days when only local shares are traded in the market;
• identifying and monitoring a foreign government’s capital restrictions to assess the impact on the fund’s ability to realize its investments and applying a consistent methodology to value holdings in such circumstances.

For the latter point, relevant sources of information to assist in arriving at an appropriate value for each investment holding would be similar to those discussed above for foreign investments.

**Illiquid investments**

An extensive international capital market offers funds the opportunity to invest throughout the world. Funds may invest directly in foreign investments and currencies or modify other investments through the use of derivative products. Each of these investments may have features that require specific accounting or auditing considerations. Each foreign security market will have varying securities regulations, taxation laws and standards regarding the availability and timeliness of market values and other corporate information. In addition, instability in a foreign country may affect the liquidity of the investments.

The ability to hold illiquid investments within a portfolio presents three particular areas of concern for an investment fund: first, the ability to meet redemption requests; second, flexibility for the fund manager in choosing the most appropriate investments to sell to meet redemptions; and, third, the added complexity of valuing illiquid investments and the significance of such holdings to the portfolio’s NAV.

Addressing the first two areas, securities regulators typically place restrictions on the amount of illiquid investments a fund can hold.\(^3\) Determining that an investment is illiquid drives the extent to which additional procedures or alternative valuation methodologies may be required to value that investment, since market quotations may not be available or may not be reliable. There is a need, therefore, to consider whether it is appropriate to fair value such an investment.

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\(^3\) NI 81-102 defines an “illiquid asset” as a portfolio asset that cannot be readily disposed of through market facilities on which public quotations in common use are widely available at an amount that at least approximates the amount at which the portfolio asset is valued in calculating the NAV per security of the mutual fund.
Often, the process of determining the liquidity of a portfolio investment is subjective, reflecting judgments about a fund’s practical ability to sell an investment in less active or specialized markets as well as meet the criteria of any regulatory definition of illiquidity. A system of controls is needed to ensure that all investments are being assessed in a consistent manner (for example, the use of a “stale price” report that identifies all investments whose close price has not changed for the last five business days). Typically, guidelines will be established, both for identifying illiquid investments at the time of purchase and for assessing developments that might require investments to be reclassified as liquid or illiquid, as appropriate.

Such developments might include, for example:

- corporate events, such as bankruptcy, default or delisting;
- registration of previously restricted investments;
- changes in the depth of markets provided by market makers;
- changes in the number of market makers for thinly traded investments;
- changes in trading practices or markets, especially in emerging markets (such as changes in rules on free trading of investments by foreigners and changes in overall trading volumes in particular markets);
- market dislocations that may cause investments to become illiquid for limited periods;
- other indications, such as an investment sold very infrequently or where the market for the investment is thin, undermining the reliability of market quotations.

Procedures should again be designed to facilitate consistent application of the relevant criteria in both determining the illiquidity of the investment and assessing the resulting fair value.

**Early market closings**

When stock markets have an early closing, investment funds generally follow one of two policies. These policies spell out until what time investor trades are accepted as a current day trade, after which trades will be executed the following day. Some funds indicate that trading in their units/shares will be on the same day if orders are received before 4:00 p.m., while others indicate that orders must be received before the close of the Toronto Stock Exchange (TSX).

This creates an inconsistency in the market place. Both methods are appropriate, if treated properly. If a fund chooses to accept trades up to 4:00 p.m., it will arguably be allowing investors to trade at the NAV per security struck at that time. The values of the investments may, however, be based on the NAV determined at the market close. This is generally acceptable. In most cases, there would not be any difference in values between the two times. Market closes are often timed for holidays, and little, if any, market information comes out during that time.

If information does come out that may affect values, funds that allow trades until 4:00 p.m. to receive current-day prices should consider the appropriateness of closing market prices. It may be appropriate to utilize fair values for either a particular investment or an entire market, depending on what news is released. This will be all the more crucial if the market has closed early because of market stresses, either as a result of reaching “circuit breaker” thresholds or due to severe imbalances or volumes causing a stock exchange’s computers to crash.

In such circumstances, it may not be appropriate to allow investors to redeem units at a NAV per security based on investment values that are stale by the time the NAV per security is struck. For instance, what if markets are crashing and the TSX shuts down while the New York Stock Exchange (NYSE) continues to
plunge? Or if both markets close early but important government announcements are made that will likely result in significant further market declines? Again, consideration should be given to the appropriateness of the NAV per security at which investors are transacting with the investment fund.

**Foreign exchange rates**
In determining the value of investments trading in currencies other than Canadian dollars, the value is determined as the product of the value of the investment in its local currency and the current foreign exchange rate. To be consistent with both regulatory and fiduciary requirements, the timing of the rate used should be consistent with the time as of which fund NAV per security are determined, typically 4:00 p.m.

Some investment funds may use earlier times, such as 12:00 noon, to determine the applicable foreign exchange rates. On days when foreign exchange rates do move significantly during the afternoon, the earlier rate may no longer be appropriate and may need to be adjusted to reflect the 4:00 p.m. rates.

**Money market investments**
A money market fund may be defined as a fund whose investments are primarily or exclusively in short-term debt investments designed to maximize current income with liquidity and capital preservation, usually maintaining NAV per security at a constant amount.

Short-term investments, such as treasury bills and other government obligations, commercial paper, bankers acceptances and certificates of deposit, may be bought at face amount or at a discount from face amount. Such investments are typically valued at cost or amortized cost on the basis that such values approximate market value. Market value is calculated at current value on the basis of trade or bid and ask prices, or at fair value. Where money market funds use cost or amortized cost as the basis for determining the NAV per security, values should be compared to market values on a periodic basis (this is called “shadow pricing”).

Although the amortized cost of money market instruments that mature within a relatively short period usually approximates market value, an impairment of an issuer’s credit standing or unusual changes in interest rates can significantly affect the market value. In such circumstances, amortized cost may not approximate the market value of the investments. This would dictate that the investments should be valued at fair value.

Use of the amortized cost method for valuing money market funds’ investments does not eliminate the need for those funds to determine the market value of their investments. The governing bodies of money market funds using the amortized cost method should establish procedures under which the extent of the deviation, if any, of the current NAV per security calculated using available market quotations (or an appropriate substitute that reflects current market conditions) from the money market fund’s amortized cost price per unit/share is calculated and reported. To calculate this deviation, money market funds “shadow price” the fund’s portfolio.

Normally, a fund’s primary pricing group performs the shadow pricing calculations, which will be derived in the same manner as valuations for the same or comparable investments held by other funds within the complex. These calculations are not necessarily performed daily, but rather at the intervals called for under the pricing procedures. The procedures may provide for shadow pricing calculations to be performed more frequently if there are unusually large changes in market interest rates or if the governing body requests it.

Fund procedures often provide for the calculations to be performed as often as daily during any period that market NAV per security deviates from $1.00 per unit/
share (or $10.00 per share/unit, as the case may be) by more than a specified threshold amount. In addition, fund procedures normally provide for periodic review of the amount of any deviation that is revealed through shadow pricing. As long as the deviation does not exceed a specified threshold, the results of shadow pricing should be reported to the governing body at its regular meetings. If the specified threshold is exceeded, corrective actions may be required, including reverting to mark-to-market valuations.

**Objectives, Risks and Control Measures**

The core objectives of the valuation of investments, together with corresponding risks of not meeting the objectives, are summarized in Exhibit 4.5.

The primary objective in the valuation of investments is to consider all events and circumstances that may affect their underlying value so that the fund’s NAV can appropriately reflect the current value of the investment portfolio. The valuation of investments requires judgment, which may be based on viewing them on a spectrum – the more complex the investment, the more judgment is needed, the greater the risks and the greater the need for control measures. The more complex the investments, the greater the need for specially designed and specifically defined valuation processes. In the Study Group’s view, the primary focus of the fund manager and the auditor should be on areas of high risk. The valuation methodology used in risky areas should be triggered by specified criteria and should be assessed for appropriateness and effectiveness.

The assessment of key risks associated with a particular investment fund is influenced by the type(s) of investment vehicles used and the investment strategies followed. The main investment vehicle groupings for most investments funds are cash and temporary investments, fixed income investments (such as bonds and debentures), equities, and derivative financial instruments (such as forwards, futures, swaps and option contracts). Each group has distinct characteristics and related valuation risks. In addition to varying degrees of overall inherent risk, the different types of investments may be recorded and monitored using different processing systems and client personnel, each with varying strengths and weaknesses. For these reasons, it is important that risks be assessed separately for each major investment grouping (and/or specific investments) within the investment portfolio to ensure that risk assessments are properly focused.

**Exhibit 4.5**

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<thead>
<tr>
<th>Core Control Objectives</th>
<th>Corresponding Risks</th>
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| Accurate, timely and appropriate frequency of valuation of investments | • Investment fund does not value its portfolio at the day and frequency determined by the governing body in accordance with the fund’s constating documents.  
• Investment is not valued, where applicable, using an appropriate market price on the valuation date. |
| Reasonable and good faith valuation of investments that have no readily available market price | • Investments and other financial instruments that have no readily available market price are not valued based on estimated value determined in good faith (fair value).  
• The fund manager, trustee and governing body do not consider all the relevant factors to ensure that estimated value is reasonable. |
| Accurate valuation of foreign investments at current market value at current exchange rate | • A foreign investment is not valued at its most recent closing price or taking into consideration developments that occur after the closing of the principal market in which the investment trades. |
| Appropriate valuation of investments with early market closings | • The method used for valuation is not consistent and is not treated properly. |
| Appropriate and accurate valuation of money market investments | • Investments are not accounted for at current value on the basis of trade or bid and ask price or at fair value.  
• Impairment of an issuer’s credit standing is not appropriately reflected in fair value.  
• Amortized costs are not calculated correctly. |
When assessing the risks associated with the accurate valuation of investments, it is important to consider the factors that can affect an investment fund’s ability to accurately value or account for its portfolio and portfolio transactions, including:

- the experience the fund accounting staff and investment advisers have with the new strategies or investment vehicles;
- the complexity of the transactions;
- the liquidity or ability to sell the investment at the ascribed market value taking into account the available public market, the size of the block of investments, general market conditions and regulatory restrictions;
- the valuation source, including the ease of obtaining a market value from a publicly available source and assessing the competence and independence in the valuation of the expert, such as a broker;
- the processing and whether the transactions are cumbersome or complex to process, thus making them more prone to clerical errors;
- the regulatory requirements that may restrict the use of specific investments or the make up of the overall portfolio strategy;
- the tax implications of each investment and the complexity of the issues.

Exhibit 4.6 sets out control measures for assessing the valuation of investments.

### Exhibit 4.6

<table>
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<tr>
<th>Control Measures for Assessing Valuation of Investments</th>
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</thead>
<tbody>
<tr>
<td><strong>A. Objective(s) and strategy</strong> – Consider the fund’s investment objective(s) as stated in the constating documents. What investment strategy is being followed? Is it consistent with, and supportive of, the investment objective? What type(s) of investment vehicles are used?</td>
</tr>
<tr>
<td><strong>B. Policies and procedures</strong> – Consider what valuation policies and procedures are in place. Are they appropriately documented? How are the policies generally applied? How are special circumstances dealt with? Are the valuation techniques appropriate? Are individuals properly trained and supervised?</td>
</tr>
<tr>
<td><strong>C. Daily fluctuation review</strong> – Consider whether the daily NAV per security and individual investments are reviewed for reasonableness in comparison with the prior day’s NAV per security and market indices or other financial data. Are any unusual changes beyond predetermined tolerance levels followed up? Are significant variances between current and prior values investigated to determine the accuracy of market values?</td>
</tr>
<tr>
<td><strong>D. Investment sub-ledger reconciliations</strong> – Consider whether an appropriate official regularly prepares, reviews and approves reconciliations of the investment sub-ledger to the custodian statements and to the general ledger.</td>
</tr>
<tr>
<td><strong>E. Other valuation assessments</strong> – Consider whether the investment adviser reviews investment balances by type, cost and market value on a regular basis for reasonableness, compliance with securities regulations and conformity with underlying knowledge of investment trades.</td>
</tr>
</tbody>
</table>

1. Does an appropriate official or pricing committee review and approve internally developed estimates of fair values?
2. Are foreign investments reviewed for proper currency translation?
3. Are cost and market value of investments reviewed for possible valuation adjustments?
4. Is the variance between amortized cost and market value of money market portfolios reviewed to ensure it is insignificant and within limits established by the governing body and/or allowed by regulators?
5. Is there a review of procedures applied by pricing services in obtaining or establishing valuations?
Chapter 1 introduced the concept of an integrated risk/control framework separated into four broad areas – nature of business, governance, operations and compliance. Chapters 4, 5 and 6 address the third part of the Investment Fund Risk/Control Framework, which is reproduced below. This chapter examines investment fund operations regarding fund accounting and reporting.

Investment Fund Risk / Control Framework

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<td>Agency Relationships</td>
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<td>Valuation of Investments</td>
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<tr>
<td>Fund Accounting and Reporting</td>
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<tr>
<td>Information Systems</td>
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</table>

For this component of the framework, the key risk elements encompass the net asset value (NAV), calculating the NAV per security, pricing errors, financial reporting, the management report on fund performance (MRFP) and performance reporting.

**FUND ACCOUNTING AND REPORTING**

As noted in Chapter 4, agency relationships may include fund accounting and reporting functions generally handled by a group known collectively as “fund accounting.” The fund accounting group generally performs the following essential functions:

- calculation of the NAV per security;
- financial reporting to both internal and external users of the fund’s financial information;
- determination of periodic distributions;
- fund performance calculations and reporting.

For those purposes, the fund accounting group must diligently maintain and reconcile the general ledger and related subledgers on a daily or frequent basis, focusing on completeness, accuracy and timeliness of transaction recognition.

As well, to maintain the records and prepare the required reports, fund accounting will receive inputs and information from a number of other groups or systems, including the transfer agent, custodian, corporate accounting and investment adviser. In effect, the fund accountant is required to “close the books” and create new financial statements for each fund on every fund business day. As a result, the internal controls and processes associated with the fund accounting and valuation functions are generally substantially more rigorous than you would find in a more conventional business entity.

**Net Asset Value**

A fundamental feature of open-ended investment funds is that their units/shares are in continuous distribution, permitting new investors to purchase units each day at that day’s NAV per security. In addition, investors are entitled to redeem their units on demand and receive their pro-rata share of the fund’s overall NAV. The NAV per security is the amount of net assets attributable to each unit of capital outstanding at the close of the period.

Closed-end funds and other specialty funds often have restrictions on when units can be purchased or redeemed, but the fundamental concepts of the NAV per security calculation remain the same. Beginning in October 2006, the procedures for valuing investments,
which represent a critical component in calculating NAV, were changed for financial statement reporting. This has not affected how investor transaction NAV (the trading NAV) is calculated.

Because a fund’s NAV per security is used for all trading activity, the NAV calculation is the most important function of the fund accounting department. If the NAV per security is computed incorrectly, or the incorrect day’s NAV per security is used, the units purchased and redeemed will be incorrectly calculated. Determining the daily NAV per security requires the accurate, complete and timely recording of:

- investment transactions, usually on the day following the trade date (trade date plus one);
- unit sales and redemptions (also usually on trade date plus one);
- the daily accrual of investment income and fund expenses;
- investments at “market value.”

It is important not to lose sight of this unique aspect of investment funds (particularly open-end funds) when assessing risks and developing control measures. This may require consideration of control measures at several servicing agents because the fund accountant generally calculates the NAV per security, which the transfer agent then applies to the purchases and sales of units/shares. In addition to control measures in effect at both of these service providers, other groups, such as the fund manager, may perform certain control procedures over the accuracy of the NAV per security.

The NAV per security is also the basis for calculating performance information used for comparative purposes. In addition, a fund’s net assets are used as the basis for fee calculations (management fees, some types of service fees, investment advisory fees, trailer fees, etc.) and, for some funds, for calculating performance bonuses for investment advisers. In view of the pervasive effect on investment funds, NAV considerations have been integrated with each component of the “Operations” part of the risk/control framework discussed in this chapter.

**Calculating the NAV**

Each line item on a fund’s Statement of Net Assets factors in the daily (or periodic, depending on the pricing frequency of the fund) calculation of the fund’s NAV. For this reason, the fund accounting department must establish appropriate controls to ensure that it is able to accurately and completely determine and record all of the asset, liability and investor (including number of units outstanding) balances each day for each class of units. In addition to accuracy and completeness, the consistency of the accounting approach used to record each item is critical, particularly for items such as investment valuation and income and expense accruals.

Although different fund types will have certain unique assets, liabilities and income and expense items, which require corresponding unique controls, the key risk management activities and control structures that must be in place to ensure an accurate NAV is calculated each day are often similar. They would include considerations such as:

- **Investments:** Have all transactions been completely and accurately recorded? Has the investment sub-ledger been reconciled to the general ledger and custodial records? Has investment income been properly accrued? Has the tax treatment for investment transactions been properly assessed and recorded? Have the valuation procedures been appropriately applied? The investment portfolio of a fund usually represents the vast majority of a fund’s assets. For this reason, any breakdown in controls relating to this balance can result in material errors. A detailed discussion on the various aspects of investment val-
valuation is included in Chapter 4 under the heading “Valuation of Investments.”

- **Cash**: Has the fund accounted for all cash balances? Have appropriate foreign exchange rates been applied to cash held in foreign jurisdictions? Is there any reason to believe that cash may not be accessible due to foreign government restrictions? Although traditional controls over cash balances, such as bank reconciliations, should be in place, additional controls are needed because of the high volume of significant cash flows and the possible wide array of cash balances – particularly in global investment funds.

- **Receivables/Payables**: Are receivables and payables appropriately revalued each day? Are there sub-ledgers in place to track and reconcile accrued balances on a daily basis? Most of an investment fund’s transactions are usually settled in a relatively short time frame and, therefore, issues surrounding the valuation of receivables and payables do not often arise. The largest items generally relate to investments bought or sold and capital unit transactions, all of which generally settle on a “trade date plus one” or “trade date plus three” basis. For certain items, such as complex expense allocations and foreign taxes withheld, however, the accrual and reversal process can require management estimates or oversight and, therefore, specific controls should be in place.

- **Investor Capital and Units Outstanding**: Have all capital transactions been received from the transfer agent, reconciled to the cash/accrual balances and properly recorded in the general ledger? Have gains/losses arising from errors been reported and accrued? Has the capital been appropriately allocated among share classes?

- **Income and Expenses**: Have all income and expense items been appropriately accrued and recorded? Are interest and dividend accruals complete and verified? Are expenses accrued on a consistent basis and in line with the fund manager’s expectations in terms of expense ratios? Have taxes, where applicable, been appropriately accrued? A more detailed discussion on the recognition of income and expense items is set out later in this chapter under the heading “Fund Financial Statements.”

Along with these daily procedures and control structures, the calculation of the NAV requires various levels of supervisory controls that are essential to minimize pricing errors. These would include policies and procedures that address:

- variance analysis to explain day-over-day changes to a fund’s NAV per security;
- review of unusual transactions such as unique corporate actions;
- appropriate decisions related to unreconciled balances;
- calculation of the NAV for every share class of every fund and that these NAVs are delivered to the transfer agent in time for use in the overnight transaction processing;
- completeness and accuracy of all fund distributions and appropriate record keeping;
- timely resolution of any pricing errors.

**Pricing Errors**

Notwithstanding a fund accounting department’s best efforts, pricing errors do occur in most mutual funds. Pricing errors result from either human or systems failures. When such errors occur, a number of issues merit consideration. They include standard of care, materiality, the period over which the error affected the fund’s NAV per security and the organization’s processes for correcting under- and overvaluations. To provide guidance to the industry in dealing with
Assessing Risks & Controls of Investment Funds

pricing errors, in August 2000, the Investment Funds Institute of Canada (IFIC) published Bulletin Number 22 Correcting Portfolio NAV Errors. Set out below is a brief discussion of certain of the items discussed in that document.

Should a material pricing error occur, determining whether a particular party (including, for example, the investment adviser, custodian or pricing agent or a third-party pricing source) will reimburse a fund or affected investors will be based on the facts and circumstances of the specific situation, the extent of that party’s culpability and the applicable standard of care. The applicable standard of care may be established by contract. For example, the investment advisory contract may provide that the investment adviser is liable to the fund should errors arise due to the adviser’s gross negligence. In some cases, an investment adviser or other service provider may voluntarily pay financial compensation to correct a pricing error without regard to the applicable standard of care, even though this is not required.

Retroactive corrective action may not be necessary if the amount of the pricing error is immaterial. Although there is no uniform, definitive test for determining materiality, it is generally accepted that a pricing error is material if a reasonable investor would consider it important. In the IFIC bulletin referenced above, the materiality threshold is set out in Section B of the guideline as 0.5% of NAV. There is a further consideration that looks through to the materiality of the impact on the individual investors.

Correcting undervaluations

When material pricing errors lead to an understatement of a fund’s NAV per security, investors who purchase fund units/shares at that price will receive too many fund units/shares for their investment, while redeeming investors will receive too little money for the units/shares they redeem. Different types of corrective action are appropriate to address each of these results.

Since most errors are caught before confirmations or account statements are issued to investors, reprocessing may be a viable method for correcting undervaluations. When statements have already been issued, many fund groups view such reprocessing as an unattractive option due to both investor relations and cost considerations. Moreover, reprocessing is not possible for purchasers who have since redeemed all of their units/shares. An alternative to reprocessing individual accounts is a lump sum payment (typically, by the fund manager) to the fund equal to the additional amount that unit/share purchasers would have paid during the relevant period had the unit/share price been computed correctly, net of the dollar amount that should have been, but was not, paid to redeeming investors. The effect on redeeming investors can be corrected only by paying those investors amounts equal to the shortfalls in the redemption proceeds they received.

Correcting overvaluations

When pricing errors lead to an overstatement of a fund’s NAV per security, the effects of the errors are reversed. Investors who redeem their units/shares during the period of overvaluation will receive too much money from the fund, while investors purchasing units/shares during that period will receive too few units/shares for their investment.

Funds compensate investors who purchase units/shares during the relevant period by reprocessing their investor accounts and increasing the number of units/shares they hold to the proper amount. Since an increase in the number of units/shares in an investor’s account usually has only a minimal adverse effect on investor relations, the primary consideration associated with this type of reprocessing is cost. Conversely, few if any funds would seek to recover the extra dollars paid to redeeming
investors, even though such recoveries theoretically are possible. Instead, overvaluations with respect to unit/share redemptions usually are corrected by paying the fund an amount equal to the difference between the dollar amount actually paid to the redeeming investors and the lower amount that would have been paid had NAV been correctly calculated.

**Financial Reporting**

Beyond the daily NAV calculation, a number of other procedures require the attention of the fund accounting group: financial reporting, periodic reconciliation procedures, performance calculations and various variance analyses.

In June 2005, the CSA published National Instrument 81-106 *Investment Fund Continuous Disclosure*. This document applies to all investment funds in Canada and spells out detailed specific disclosures that need to be included in a fund’s financial statements, MRFP and quarterly portfolios.

**Financial statements**

The annual and semi-annual financial statements must be prepared in accordance with GAAP and must include a Statement of Net Assets, Statement of Operations, Statement of Changes in Net Assets, Statement of Investment Portfolio and applicable notes to the financial statements. NI 81-106 sets out very specific details as to what must be included in each of these components of the financial statements. NI 81-106 also includes very prescriptive details on the form and content of the MRFP and what it must include. Because of the nature and usage of certain of the information contained in these documents, rigorous controls should be established for their preparation.

The following discusses what the fund accounting group should consider when preparing these financial statements and reports.

- **Statement of Net Assets**: the bases for determining the reported amounts of assets and liabilities should be applied consistently and, where the bases are not self-evident, they should be disclosed. This statement generally sets out traditional balance sheet information along with unique disclosures for investment funds, per security data by class of shares and total net assets by class of shares where applicable.

- **Statement of Operations**: separately classifies net investment income or loss, and net realized and unrealized gains and losses from investments for the accounting period. The objective of this statement is to present the increase or decrease in net assets resulting from an investment fund’s activities. It achieves this by reporting:
  - investment income from dividends, interest and other income, less expenses;
  - amounts of realized gains or losses from investment and foreign currency transactions; and
  - changes in unrealized appreciation or depreciation in the value of investments and foreign-currency-denominated investments and other assets and liabilities for the period.

That format helps users understand the contribution of each aspect of investment activity to the fund’s overall operations.

The expenses of an investment fund merit unique consideration because investors tend to be particularly concerned about the fund’s “management expense ratio” (MER) and the direct impact expenses have on a fund’s performance. Consequently, NI 81-106 provides a detailed list of expenses that must be disclosed in the Statement of Operations – regardless of their absolute amount. Greater disclosure than might otherwise be warranted is desirable because:
expenses are a direct reduction in the total return of the fund;
the nature of expenses charged to the fund must comply with the provisions in the offering document;
the MER is a key marketing tool for many fund managers; and
in many circumstances, a substantial amount of the total expenses are incurred through related party agreements.

Regulations usually stipulate that a fund’s prospectus should disclose which expenses are charged to the fund, which expenses are paid for by the fund manager and which expenses are borne directly by the investors. Expenses, such as management fees, which are calculated as a percentage of the fund’s net assets, should be calculated and accrued daily. To prevent the fund’s NAV from fluctuating due to the timing of expenses, expenses for the entire year should be estimated and accrued evenly over the year, generally daily. The complexity of this process has increased significantly in recent years with the proliferation of multiple share classes within the same fund. The allocation process is often a two or three-step process – first determining which expenses need to be allocated to the fund and a second iteration to allocate the amounts charged to each fund across any classes or series of units/shares that may exist. The fund manager would review the estimates of annual expenses continually and adjust the accruals as required.

Certain expenses, such as income taxes, may not lend themselves to an easy smooth daily accrual process. Most funds minimize the amount of tax they pay by distributing earned income to investors, where it is taxed in their hands (see the following section on distributions). In other cases, funds may be obliged to pay tax within the fund (in corporate class structures, for instance), requiring careful monitoring of potential tax liabilities.

- **Statement of Changes in Net Assets:** generally replaces the Statement of Cash Flow used in other financial statements, although specific circumstances may require that a Statement of Cash Flow also be included. This statement provides information for each class of shares. The detailed information includes changes in the fund’s net assets resulting from operations, capital unit or share activity and distribution activity.

- **Statement of Investment Portfolio:** provides a snapshot of the investment fund’s holdings at the statement date and an indication of how closely the investment fund is following its investment objectives at that date. In addition to being included in the annual and semi-annual financial statements, a statement of investment portfolio forms the basis of the information included in the “Quarterly Portfolio Disclosure” which is required to be prepared at the end of the first and third quarters of an investment fund that is a reporting issuer. Investors, analysts and other interested parties use all of this information to monitor the investment adviser’s activities, and this statement should be prepared and disclosed with a view to this use.

- **Notes to financial statements:** include not only traditional GAAP disclosure but also a number of items prescribed by regulation that are specific to investment funds.

In addition, the notes must include a detailed description of any related party transactions. As previously mentioned, some or most of a fund’s expenses are the result of an arrangement with a related party. Usually, the largest single expense is the management fee paid to the fund manager. This
fee is calculated using one of the following methods:

- a specified percentage of the average daily NAV of the fund;
- a sliding scale in which the specified percentage is reduced when the NAV of the fund is in excess of a specified amount;
- a sliding scale based on an investor’s investment in the fund and other funds of the same family; or
- a performance fee schedule that consists of a basic amount plus a bonus for good performance or minus a penalty for poor performance.

It should be noted that fund managers typically charge back to a fund any costs they have borne on behalf of the fund, as provided by the prospectus or other offering document. Often, expenses such as salaries, rent and systems costs must be allocated among fund-related activities (charged to the fund) and corporate activities. Such attribution should be done on a consistent and reasonable basis. Conversely, a number of fund companies have switched to a “fixed operating expense” approach. Under this scenario, the fund manager effectively pays all of the operating expenses of the investment fund and then charges a fixed annual administration fee (in addition to the standard management fee). This administration fee usually covers all of the variable operating expenses except certain non-controllable costs such as taxes, other government fees, borrowing costs and IRC costs.

Two other large expenses that may or may not pertain to related party agreements are custodial fees (usually based on a combination of asset value and transaction activity), and investor record keeping (transfer agency) costs (usually based on asset values, the number of accounts, investor activity or a combination of these). Alternatively, these functions may be outsourced to third parties.

Significant provisions of related party agreements, including the basis for determining management, advisory, administration or distribution fees, as well as other amounts paid to affiliates or related parties, must be described in the notes to the financial statements. If legal requirements or the advisory agreement provide that an adviser should reimburse a fund for expenses in excess of a specified percentage of average net assets, the contract terms and the amount of reimbursement, if any, should be disclosed.

If a fund manager voluntarily waives all or a portion of the stipulated fee, or voluntarily absorbs other fund expenses, the amount waived or absorbed must be disclosed in the statement of operations and the impact on the MER must be reflected in the MRFP.

Differences from Canadian GAAP
Canadian GAAP (Generally Accepted Accounting Principles) requires that the fair value of financial instruments (specifically, portfolio securities held by the fund that are actively traded) be measured based upon the bid price for the security, instead of the closing price or the last sale price of the security for the day. This requirement will be reflected in the reported value of the fund’s investments in its annual and interim financial statements, as these financial statements are prepared in accordance with Canadian GAAP. In accordance with recent amendments to National Instrument 81-106, however, the fair value of a portfolio security used to determine the daily price of the funds securities for purchases and redemptions by investors will continue to be based on the closing price, which is not the same as the Canadian GAAP requirements.
Management Report of Fund Performance (MRFP)
The MRFP is designed to provide investors with the information they need to understand a fund’s key financial trends, why the fund performed as it did over the previous period and how the fund’s investments are positioned in the current market. The required disclosures include:

- Management Discussion of Fund Performance, including a discussion of a fund’s objectives, risk, results of operations, recent developments and related party transactions;
- Financial Highlights, including key ratios and supplemental data; and
- Summary Portfolio Information, including the current investment portfolio characteristics.

Management Discussion of Fund Performance
This section elaborates on the investment objective and risk disclosures contained in a fund’s prospectus. Consistency across these documents should be monitored. In addition, this area of the MRFP discusses the Investment Adviser’s views on recent performance and investment activity and, therefore, should be subject to the same scrutiny and control oversight as would be used for traditional non-audited management discussion and analysis. Guidance for preparing and reviewing these types of disclosures is available from the regulators as well as the accounting firms.

Financial Highlights
The financial highlights include key ratios and supplemental data, such as fund performance, that are critical in understanding a fund’s activity as well as providing a useful means for comparison across funds. Specific guidance included in the regulations dictates what must be included and the manner in which certain ratios must be calculated. Because of the sensitivity of this data and its broad use by stakeholders, the fund manager should ensure that there are clearly defined preparation and review controls in place. The key attributes of the controls will focus on the accuracy and consistency of the information, and ensuring that it meets regulatory requirements.

Summary Portfolio Information
The portfolio information provides various characteristics of a fund’s portfolio at a particular point in time. This data is generally available on a daily basis from the fund accounting records. Key controls over the preparation of this information would focus on the completeness and accuracy of the data as at the reporting date.

Distributions
Most investment funds pay distributions to their investors pursuant to the information included in the fund’s constating documents. Depending on a fund’s legal structure and the decisions of the fund manager, the distributions will generally be characterized as capital gains, investment income or return of capital. The calculation of the amount to be distributed can be a complex process and, if done incorrectly, can lead to undesired tax liabilities to the fund, investors or both parties.

Some of the unique tax characteristics of investment funds include the following:

- Many funds are organized as “mutual fund trusts” and pay out all taxable income earned pursuant to set rules that maximize tax efficiency for investors.
- Other funds are organized as “mutual fund corporations” and pay tax on certain investment income earned but pay out all realized capital gains and Canadian dividends.
- Certain funds are able to make use of special provisions that allow them to permanently retain some of their realized capital gains without incurring any tax in the fund.
• Many large fund complexes have “corporate class structures” – these are groups of funds organized under a single corporate entity that allow investors to move between funds without triggering a capital gain or loss. These structures have unique issues related to sharing expenses and allocating gains that need to be considered each year.

• Distributions for trust entities must be paid or payable on or before the last business day of the calendar year.

These and other unique aspects of investment fund distributions require specially trained individuals to operate within a disciplined control environment to minimize the risk of a material miscalculation in determining the periodic distributions of a fund.

Performance Reporting
In addition to being the basis for investor transactions, the NAV per security is the core component of calculating fund performance.

NI 81-106 includes specific instructions as to how performance must be calculated and requires that an investment fund’s performance be included in the financial highlights section of the MRFP for the most recent five fiscal years. Financial highlights should be presented for each class of shares or units outstanding. Securities regulations also provide specific guidance and requirements for fund companies wanting to use fund performance in their marketing and advertising materials. NI 81-106 further provides specific instructions as to what methods to use in calculating certain other disclosures, such as MERs, total expense ratios and portfolio turnover rates.

In addition to the financial highlights, an investment fund’s MRFP must include a section on past performance. As with the financial highlights, NI 81-106 provides specific guidance as to what information this section should include and how the performance numbers are to be calculated and presented.

Objectives, Risks and Control Measures
The core objectives of the fund accounting function, together with corresponding risks of not meeting the objectives, are summarized in Exhibit 5.1.

The Study Group identified a number of factors or conditions that may influence the assessment of risk inherent in fund accounting functions, including the following:

- nature of, and circumstances surrounding, contractual arrangements with service providers;
- complexity of share structures and fund-on-fund arrangements requiring judgments about allocations of income and expenses;
- dissatisfaction with performance of service providers;
- backlogs in processing or completing reconciliations;
- repeated errors in the computation of the NAV;
- cash management problems (for example, excess cash balances, unexpected overdrafts or untimely expense payments);
- inadequate cash availability reporting for daily investment purposes;
- significant fluctuations in expenses or ratio of expenses to net assets;
- staff turnover, staff training and regulatory changes.
Exhibit 5.1

<table>
<thead>
<tr>
<th>Core Control Objectives</th>
<th>Corresponding Risks</th>
</tr>
</thead>
</table>
| Accurate and timely determination of the periodic NAV per security                      | • Inputs into the process from other departments are not complete, accurate and timely.  
• Processing of daily accruals and transaction activity is not complete and accurate.  
• Calculation of NAV per security is incorrect.  
• NAV per security information is not provided to other operational areas (e.g., transfer agent, performance department) on a timely basis. |
| Complete, accurate and timely financial reporting                                       | • Processing of daily accruals and transaction activity is not complete and accurate.  
• Calculations for periodic data are not accurate and consistent (e.g., MERs, turnover, performance).  
• Procedures affecting cut-off are insufficient or unreliable.  
• Reporting does not comply with regulatory requirements. |
| Accurate periodic distributions to investors                                             | • Tax characterization of distributions is inaccurate.  
• Processing of daily accruals and transaction activity is not complete and accurate.  
• Allocation methodology by income type and by share class is inappropriate or incomplete.  
• Distribution per unit information is not provided to other operational areas (e.g., transfer agent) on a timely basis. |
| Calculation of fund performance                                                         | • Calculation of NAV per security is incorrect.  
• Performance calculation methodology is incorrect and/or inconsistent.  
• Controls over dissemination of performance data are unreliable. |
| Maintain accurate books and records                                                     | • Recordkeeping systems are unreliable or insufficient.  
• Processes and procedures are not well documented and inconsistently applied.  
• Inputs from other departments are unreliable and inconsistent.  
• Staff are not sufficiently qualified to perform their duties. |

New or significant transactions may also represent areas of increased risk, for example:

- frequent changes in bank accounts or authorized signatories;
- bank accounts in foreign currencies;
- the fund has or had a significant cash overdraft during the year;
- significant amounts remain in accounts payable suspense accounts;
- significant debit balances in accounts payable or extremely high payables in relation to expenses;
- the nature or amount of accruals has changed significantly;
- changes to fee arrangements (new contracts or new entities under contract);
- the fund receives goods or services in consideration for business given to a third party, such as brokerage commissions;
- complex fee arrangements, including incentive fees, net asset break points and cost reimbursement arrangements;
- conversion of systems;
- complex investments such as derivative transactions;
- securities regulations or voluntary undertakings may limit the amount of expenses incurred.

As well, prior year experience of error may indicate areas of increased risk, for example:

- cash balances were overstated or understated due to improper recognition of cash transfers between related funds;
- translation exchange rates utilized for cash balances were incorrect;
- accruals were overstated or understated (for example, management or other fees);
- translation exchange rates utilized for accounts payable were incorrect;
- improper allocation of costs to the fund by the fund manager;
- cutoff errors;
  - not all payments were recorded;
  - not all purchases or accounts payable transactions were recorded;
— recorded expenses or accounts payable did not represent services rendered;
— recorded payments did not occur in the prior year;
— not all receipts were recorded in the prior year;
— recorded receipts did not occur in the prior year.

Exhibit 5.2 sets out examples of control measures for assessing the appropriateness of fund accounting activities.

Exhibit 5.2

<table>
<thead>
<tr>
<th>Examples of Control Measures for Assessing Fund Accounting Activities</th>
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</thead>
<tbody>
<tr>
<td>• Are all critical processes and procedures documented, refreshed and followed by all department staff?</td>
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<tr>
<td>• Are staff sufficiently trained to perform daily functions and recognize unusual activity requiring further investigation?</td>
</tr>
<tr>
<td>• Is there appropriate supervisory review of all key activities, such as NAV calculations, distribution calculations and financial reporting?</td>
</tr>
<tr>
<td>• Are there appropriate reconciliation procedures in place for all key balances, such as investor balances and investment activity?</td>
</tr>
<tr>
<td>• Are all bank and cash accounts, including trust accounts, reconciled on a timely basis and suspense accounts regularly reconciled and cleared?</td>
</tr>
<tr>
<td>• Is there appropriate communication between fund accounting and other departments/agencies (transfer agent, custodian, adviser) to ensure all variances, suspense items, corrections, etc. are escalated, resolved and processed in a timely manner?</td>
</tr>
<tr>
<td>• Are procedures in place to ensure that all accounting and regulatory changes are evaluated and implemented on a timely basis?</td>
</tr>
<tr>
<td>• Are expense, income and distribution allocation methodologies reviewed on a periodic basis to ensure their continued accuracy and relevance?</td>
</tr>
<tr>
<td>• Are effective back-up procedures in place to ensure that time-sensitive information (inputs into fund accounting or outputs out of fund accounting) can be accessed in times of business interruptions?</td>
</tr>
<tr>
<td>• Are the technology systems sufficiently integrated, maintained and tested to ensure reliability of output?</td>
</tr>
<tr>
<td>• Are controls in place to ensure timely and accurate valuation of investments during periods of market interruption?</td>
</tr>
</tbody>
</table>
Chapter 1 introduced the concept of an integrated risk/control framework separated into four broad areas – nature of business, governance, operations and compliance. Chapters 4, 5 and 6 address the third part of the Investment Fund Risk/Control Framework, which is reproduced below. This chapter examines investment fund operations regarding information systems.

### Investment Fund Risk / Control Framework

**Part 3 - Operations**

<table>
<thead>
<tr>
<th>Agency Relationships</th>
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</thead>
<tbody>
<tr>
<td>Valuation of Investments</td>
</tr>
<tr>
<td>Fund Accounting and Reporting</td>
</tr>
<tr>
<td>Information Systems</td>
</tr>
</tbody>
</table>

The key risk elements of an investment fund’s information systems encompass reliance on information technology, information systems related risks, and risk management.

### RELIANCE ON INFORMATION TECHNOLOGY

Many investment funds use information technology (IT) to support their day-to-day operations, including accounting and reporting. This is particularly true of funds having a large number of investors or investment holdings or a high volume of investors or investment transactions. Funds use IT to support the volume of transactions, enhance efficiency through automation, process transactions on a timely basis and interact with other market participants that transact through electronic means.

While funds with small investment pools or few investors might find it uneconomical to develop and support their own in-house information systems, services for automating their processes and systems are available from various providers. As a result, understanding the nature and extent of IT involvement in fund operations is a critical component of understanding and evaluating the risks and controls over investment fund activities.

Technology often supports the operation and accounting for investment funds in the following areas:

- transfer agency functions;
- trust accounting;
- investment management and trading;
- asset custody; and
- fund accounting.

### INFORMATION SYSTEMS RELATED RISKS

In addition to risks that are normally associated with using technology to support business and accounting processes, the specific characteristics of investment funds create the following risks:

- Because of the need to strike a NAV at specified dates and times (often daily) and to process investor transactions shortly afterwards, coupled with regulatory requirements, funds must be able to continue to function despite technical disruptions. This risk drives the need for contingency planning.

- Extensive automation, with little human intervention, creates a need for application controls and system-enforced segregation of duties, supported by information technology controls.
The receipt of investor transactions from an industry utility (e.g., FundSERV Inc.) requires application controls that deal with suspense and reject processing.

The cost of developing and supporting in-house systems has prompted many funds to seek outsourced solutions or to partially automate functions through the use of spreadsheets or other end-user computing tools. These introduce the requirement to manage third-party relationships and manage the risks associated with end-user computing tools that are often less formally controlled than full applications.

**RISK MANAGEMENT**

IT poses significant risks for fund operations. Those charged with managing a fund should ensure that processes and controls are implemented to mitigate those risks.

Risks inherent in each of the items listed above are discussed in the following sections. This includes information technology general controls and information processing objectives, typical control objectives and controls for each of the functions listed, and considerations related to end-user computing, the use of service providers and contingency planning.

**Information Technology Controls**

Information is captured, processed and reported through a number of key business and financial applications, which in most cases are highly computerized. Key applications can be handled in-house or outsourced to a service provider. As a result, Information Technology General Controls (ITGCs) will often contribute indirectly to the achievement of many or all of the financial statement assertions. In some instances, ITGCs may contribute directly to the achievement of information processing objectives and financial statement assertions.

This is because effective ITGCs ensure the continued effective operation of application controls and automated accounting procedures that depend on computer processes. ITGCs are also important when manual controls depend on application-generated information.

The types of activities and controls that might be relevant to the effectiveness of IT include:

- how IT roles and responsibilities are defined and understood, including ownership and accountability for internal control;
- how proper segregation of duties among key IT functions is accomplished;
- the nature of IT management’s operating style and attitude towards internal control;
- the means by which an IT organization and its leadership promote a strong control environment, including adoption of, or participation in, broader entity-level control activities;
- human resource IT practices that promote integrity and reflect a commitment to competence;
- the manner of governance and oversight of the IT function, including the level of interaction with executive management, the board, and the governing body when dealing with the results of monitoring activities and identified IT control weaknesses;
- the means by which IT communicates and collaborates with operations, investment and finance functions on matters relevant to internal control over operational and financial reporting;
- policies and procedures designed to preserve the integrity of key operational financial applications and data, both within IT and outside the IT function, where applicable;
- how the company distinguishes routine program maintenance from program development activities and their related ITGCs;
- how changes in people, processes, systems, technologies and business conditions are monitored and addressed from an overall IT controls perspective;
• how management tracks, responds and ensures appropriate resolution to incidents that reflect possible control issues, such as significant security breaches or data corruption problems.

Internal control components related to IT include the means by which ITGCs are monitored for ongoing effectiveness (e.g., through some combination of direct supervisory controls, quality assurance reviews, internal audits, regulatory reviews or others).

ITGCs comprise four domains:

<table>
<thead>
<tr>
<th>Domain</th>
<th>Domain Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Program development</td>
<td>Systems are developed, configured, and implemented to achieve management’s application control objectives.</td>
</tr>
<tr>
<td>Program changes</td>
<td>Changes to programs and related infrastructure components are requested, authorized, performed, tested and implemented to achieve management’s application control objectives.</td>
</tr>
<tr>
<td>Access to programs and data</td>
<td>Only authorized access is granted to programs and data on authentication of a user’s identity.</td>
</tr>
<tr>
<td>Computer operations</td>
<td>Production systems are processed completely and accurately in accordance with management’s control objectives, and processing problems are identified and resolved completely and accurately to maintain the integrity of data.</td>
</tr>
</tbody>
</table>

See Exhibit 6.1 for typical IT General Controls.

To ensure that ITGCs appropriately support the operation of procedures, a clear link should be established among the key ITGCs and:
• key automated application controls and interfaces;
• key automated accounting procedures; and
• system-generated data and reports used in managing and controlling operations or in the generation of key financial data (e.g., manual journal entries).

See Exhibit 6.2 for examples of linkage of ITGCs to automated controls and procedures.

**Information Processing Objectives**

Within each business process and related transaction flows, management implements control activities to ensure that authorized transactions are recorded in a complete and accurate manner. Management also implements control activities to ensure that data is protected from unauthorized amendment once recorded. Collectively, these objectives are referred to as information processing objectives, as summarized below:

<table>
<thead>
<tr>
<th>Completeness</th>
<th>All transactions that occur are entered and accepted for processing once and only once.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accuracy</td>
<td>Transactions are recorded at the correct amount in the appropriate account and proper period.</td>
</tr>
<tr>
<td>Validity</td>
<td>Only authorized transactions are recorded in the financial system.</td>
</tr>
<tr>
<td>Restricted access</td>
<td>Only authorized access is granted to programs and data on authentication of a user’s identity. Data is protected against unauthorized amendments and access to data is appropriately restricted to authorized personnel.</td>
</tr>
</tbody>
</table>

See Exhibit 6.3 for detailed considerations and examples regarding Information Processing Objectives.

**Application Processing**

As transaction volumes increase, it is more cost effective for funds to implement a greater degree of automation in the processing of transactions. The following sections describe the primary control objectives associated with each business function and common automated controls that support those objectives.

**Transfer agency**

Several different types of sources of purchases and redemptions and complicated equity transactions and structures may influence the assessment of risk related to transfer agency functions.

In gaining a proper understanding of how IT supports the processing of transfer agency related transactions, it is necessary to understand how transactions from
different sources are processed. As well, in evaluating the effectiveness of controls for those different sources, it is necessary to consider the different risk characteristics of the transaction streams. For example, it is equally important that controls exist over the manual input of purchase and redemption transactions that are received by mail or fax as it is for electronic feeds of transactions from an industry utility. Controls that are effective for one stream of transactions may not, however, be effective for another.

For manually-input transactions, the following may be effective: restrictions on who can process transactions; the manual batching of transactions; on-line edit and validation checks designed to identify incomplete or inaccurate data entered; and exception reports of manual over-rides that can be reviewed by a supervisor. For electronic feeds of transactions, however, the following may be more appropriate: data transmission controls; file balancing; edit checks resulting in an error recycle file; and exception reports for manual follow-up.

In considering controls over the input, processing and output of purchase and redemption transactions, the greatest differences will lie in the transaction input process.

The primary control objectives of the transfer agency function include the following (related system/automated control activities are set out in Appendix F):

A. Controls provide reasonable assurance that investor account maintenance transactions are properly authorized and are recorded accurately and on a timely basis.

B. Controls provide reasonable assurance that transactions are authorized, processed accurately and on a timely basis and valued at proper dollar unit/share amounts.

C. Controls provide reasonable assurance that fee and commission rates are set up in the system in accordance with underlying agreements and that fee/commission calculations and payments are authorized and accurate.

D. Controls provide reasonable assurance that dividend and distribution rates are authorized, and that dividend and distribution amounts are calculated and recorded accurately and on a timely basis.

E. Controls provide reasonable assurance that tax withholdings are properly calculated, recorded and remitted.

The effectiveness of many automated controls depends on effective segregation of duties. In addition to evaluating the effectiveness of access security as part of IT general computer controls, it is necessary to assess whether access to incompatible functions within the transfer agency system or access to key functions is appropriately restricted. It is expected that access to the following functions would be restricted:

- input/finalization of daily prices;
- input of distribution rates;
- the ability to process back-dated purchase and redemption transactions;
- set-up and changes to dealers, commission and fee rates and other relevant parameters; and
- maintenance of client accounts.

Trust accounting
In gaining a proper understanding of how IT supports the processing of trust accounting related transactions, it is necessary to understand how transactions from different sources (e.g., shares trade file from transfer agent, receipt and disbursement detail from the custodian, etc.) are processed. In evaluating the effectiveness of controls for those different sources, it is necessary to consider the different risk characteristics of the transaction streams.
The primary control objectives of the trust accounting function include the following (related system/automated control activities are set out in Appendix F):

A. Controls provide reasonable assurance that cash balances are reconciled and exceptions are promptly identified and appropriately resolved.

B. Controls provide reasonable assurance that cash receipts and disbursements are authorized, processed, and recorded completely and accurately on a timely basis.

For the above controls to be effective, access to the following functions would be restricted:

- trust accounts and the interest allocation function;
- adding trust bank accounts/modifying trust bank account numbers;
- approval, printing and release of electronic cheques; and
- journal entries.

**Investment management and trading**

The typical functions associated with investment management include account management, portfolio management, transactions processing (including the authorizing and processing of trades) and custody/safeguarding of assets. To properly understand how IT supports investment management and trading processes, it is necessary to first understand how transactions from different sources (e.g., investment trade orders, security prices, prime broker/custodian feeds, etc.) are processed. In evaluating the effectiveness of controls for those different sources, it is necessary to consider the different risk characteristics of the transaction streams.

The primary control objectives of the investment management and trading function include the following (related system/automated control activities are set out in Appendix F):

1. **Account Management**
   A. Controls provide reasonable assurance that investment guidelines and restrictions are established and fund portfolios are monitored for adherence.
   B. Controls provide reasonable assurance that derivative strategies are appropriately approved.

2. **Portfolio Management**
   C. Controls provide reasonable assurance that portfolio transactions are properly authorized, executed and allocated in a timely and accurate manner.

3. **Transaction Processing**
   D. Controls provide reasonable assurance that portfolio transactions are recorded completely, accurately and on a timely basis.
   E. Controls provide reasonable assurance that transactions are undertaken only with approved counterparties.

**Asset custody**

The custodian of assets for a fund is typically an independent third party or related to the manager. As with other third parties, obtaining a report on controls from the custodian (e.g., a CICA Section 5970 report[^33]) is often the most effective way of assessing the custodian risks and controls relevant to a fund’s internal controls over financial reporting.

The fund should assess whether the control objectives in the third party report are consistent with the service

[^33]: CICA Handbook-Assurance Section 5970, “Auditor’s Report on Controls at a Service Organization,” provides guidance for auditors who issue audit reports on the processing of transactions by a service organization for user organizations and their auditors. Under this Section, two types of reports may be issued:

- reports on controls placed in operation (often referred to as a “Type I report”); and
- reports on controls placed in operation and tests of the operating effectiveness of controls (often referred to as a “Type II report”).

(See Chapter 8 for examples of these reports.)
that the custodian performs for the fund. The primary control objectives include the following (related system/automated control activities are set out in Appendix F).

A. Trades are authorized, recorded, settled, and reported completely, accurately, and timely and in accordance with the client agreement.

B. Investment income is collected and recorded accurately on a timely basis.

C. Corporate actions are identified, processed, settled and recorded accurately on a timely basis.

D. The entity’s records accurately reflect securities held by third parties, for example, depositories or sub-custodians.

If a custodian performs asset lending services for a fund, additional control objectives dealing with that function need to be established, for example, those set out below.

E. Lender and borrower participation in lending programs is authorized.

F. Loan initiation, processing, maintenance and termination are recorded accurately on a timely basis.

G. Loans are adequately collateralized and collateral is recorded accurately on a timely basis.

**Fund accounting**

To properly understand how IT supports the processing of fund accounting transactions, it is necessary to first understand how transactions from different sources (e.g., securities trade file from custodian, cash and security position file from custodian, price and dividend feeds from vendors, shares trade file from transfer agent, etc.) are processed. In evaluating the effectiveness of controls for those different sources, it is necessary to consider the different risk characteristics of the transaction streams.

The primary control objectives include the following (related system/automated control activities are set out in Appendix F):

A. Controls provide reasonable assurance that securities costs are accurately calculated and recorded.

B. Controls provide reasonable assurance that corporate actions and proxy voting instructions are identified and generated, and then processed and recorded accurately in a timely manner.

C. Controls provide reasonable assurance that investment income is complete, accurate and recorded in the proper period.

D. Controls provide reasonable assurance that investments are priced using current prices obtained from independent external pricing sources.

E. Controls provide reasonable assurance that cash and securities positions are completely and accurately recorded and reconciled to third-party data.

F. Controls provide reasonable assurance that expenses are accurately calculated, and recorded in accordance with fund prospectus and contractual obligations.

G. Controls provide reasonable assurance that net asset values are accurately calculated.

For the above controls to be effective, access to the following functions needs to be restricted:

• input/modify security trades;
• input/modify prices;
• set-up securities (including interest rates and dividend rates);
• change expense/fee rates; and
• journal entries.
Use of Third Parties

Significant aspects of the operations of investment funds are often outsourced to third parties. It is not uncommon for transfer agency, fund accounting or custody functions, including supporting technology, to be outsourced to service providers. To understand what a service provider is responsible for, it is important to first understand how technology supports the service and the processing of transactions. For outsourced services that are significant to the processing of transactions that affect a fund’s financial statements, the fund managers first need to understand the processes, risks and controls, including supporting technology risks and controls, as well as they would if the services were performed by the fund manager itself.

Where functions are outsourced to an entity that is closely related to the fund manager (for example, the parent company of fund manager), it may be possible to visit the service provider to gain that understanding of the process and controls, and to perform tests of controls and transactions as required. Other service providers, especially those providing services to a number of funds, may choose to provide information about its services and controls through a service auditor’s report such as a CICA Section 5970 report.

To properly understand and use a service provider’s report, it is first necessary to understand the respective responsibilities of the service provider and the fund manager in the processing of transactions. Understanding the contract between a fund manager and its service provider is useful in that regard. In reading a Section 5970 report, a fund manager should consider whether it adequately describes the service that has been outsourced and, together with an understanding of the processing performed by the fund manager, fully describes the end-to-end processing of significant transactions. Where the outsourced service is supported by technology, the report should include a description of IT General Computing Controls.

The fund manager should pay particular attention to the scope of any service auditor’s report.

- Service providers sometimes provide similar services from different locations or different variations of services (e.g., full hosting of an application vs. co-location). The fund manager should ensure that it has the appropriate report.

- Service providers may offer a menu of services that are covered by a single report. The fund manager should be alert to the fact that the report may describe services to which the fund manager has not subscribed, and may not include all services outsourced by the fund manager. The fund manager should perform a gap analysis to ensure the report meets its needs.

- Service providers may outsource part of their operations and their report may explicitly exclude these activities (the report is presented on a carve-out basis). If the outsourced function is significant, the fund may need to also obtain a Section 5970 report from the sub-service provider.

Fund managers should pay particular attention to the section of the service provider’s report entitled “complementary user organization controls.” These are the controls that the service provider considers the fund managers must have implemented to ensure that its own controls are adequate. From an IT perspective, these will often include controls over managing access to the service provider’s system(s) and involvement in testing system enhancements.

A service auditor’s report provides assurance on whether the description of controls reflects what occurs at the service provider and whether the controls have been
implemented (both Type I and Type II reports in Section 5970). A Type II report also provides assurance on whether certain controls are operating effectively. Fund managers should consider whether the time period covered by the service auditor’s report, taking into account the gap in time since the previous report, provides sufficient assurance on the operation of controls at the service organization to permit the fund’s governing body to have appropriately discharged its responsibilities.

End-User Computing
Fund managers often use end-user computing tools such as spreadsheets in the processing of transactions, calculation of net asset values, generation of accounting entries operation of controls (such as reconciliations) and the preparation of financial statements. End-user computing tools are not normally supported by the same control environment as formally developed or purchased applications. For example, the developers and users of spreadsheets are not usually trained in structured programming, testing, version control or systems development life cycles. Also, there are often no security controls restricting spreadsheets from unauthorized access. Nevertheless, they are an important part of the information system of funds. As a result, fund managers should assess the risks associated with significant individual end-user computing tools (e.g., individual spreadsheets) and establish controls that are responsive to the risks.

Fund managers should identify spreadsheets that are significant in generating or acting as a control over information included in the financial statements, whether this is through the routine processing of transactions or non-routine/estimation processes performed specifically for period end reporting. Having determined the significance of any tool, fund managers should also assess the complexity of the tools used (for example, whether the spreadsheet is merely totaling a column of figures or whether it involves multiple linked spreadsheets, macros, lookup functions and complex calculations). Because spreadsheets can be changed easily and may lack certain controls, they are subject to increased inherent risk and error. Typical errors that occur in spreadsheets include input errors, logic errors and interface errors.

There are controls to mitigate these risks:
- Change control, which is a controlled process for making changes, testing them and obtaining sign-off from an independent, individual verification that a change is functioning.
- Version control, which ensures that the correct version of a tool is being used.
- Input control, which is a reconciliation that ensures data are input or imported completely and accurately.
- Integrity control, which locks or protects cells to prevent inadvertent or intentional changes to formulas or standing data.
- Logic inspection, which is an inspection of the logic in critical spreadsheets by someone other than the developer/user of the spreadsheet.

In the absence of adequate controls, it is likely that the information produced by an end-user computing tool is no more reliable than if it had been produced manually.

Objectives, Risks and Control Measures
The following identifies risks and related controls associated with IT general controls (see Exhibit 6.1 and Exhibit 6.2) and information processing objectives (see Exhibits 6.3). Typical control objectives and control measures are set out for each of the functions listed.
**Exhibit 6.1 – Typical IT General Controls**

<table>
<thead>
<tr>
<th>Program development</th>
</tr>
</thead>
<tbody>
<tr>
<td>8. Management of development and implementation activities. Management should establish a process for controlling program development activities, including major system enhancements, and should monitor the effectiveness of that process.</td>
</tr>
<tr>
<td>9. Project initiation, analysis and design. Project initiation controls should ensure that projects are planned, resourced, and mobilized to support the achievement of management’s application control objectives.</td>
</tr>
<tr>
<td>10. Construction/package selection. Construction and package selection controls should ensure that in-house program development activities and the selection of packaged software support the achievement of management’s application control objectives.</td>
</tr>
<tr>
<td>11. Testing and quality assurance. Testing and quality assurance controls should ensure that appropriate personnel perform an adequate level of testing to determine that the new system functions as intended and achieves management’s application control objectives.</td>
</tr>
<tr>
<td>12. Data conversion. Data conversion controls should ensure that data is converted completely and accurately to new systems.</td>
</tr>
<tr>
<td>13. Program implementation. Program implementation controls should ensure that new systems are implemented in a live environment only after adequate testing, obtaining business sponsor approval and developing proper implementation and back-out plans.</td>
</tr>
<tr>
<td>14. Documentation and training. Documentation and training controls should ensure that end users and technical support personnel are given adequate documentation and training concurrently with program implementation.</td>
</tr>
<tr>
<td>15. Segregation of duties. Segregation of duties controls should ensure that the roles and responsibilities throughout the program development process have been appropriately restricted and segregated.</td>
</tr>
</tbody>
</table>

Within each of the four domains of IT General Controls, a fund would normally have controls in the following areas:

<table>
<thead>
<tr>
<th>Program changes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Management of maintenance activities. Management should establish a process for controlling program changes and monitor the effectiveness of that process.</td>
</tr>
<tr>
<td>2. Specification, authorization and tracking of change requests. Change request controls should ensure that user requests are captured, authorized and prioritized to support the achievement of management’s application control objectives.</td>
</tr>
<tr>
<td>3. Construction. Construction controls should ensure that changes are developed and performed to support the achievement of management’s application control objectives.</td>
</tr>
<tr>
<td>4. Testing and quality assurance. Testing and quality assurance controls should ensure that appropriate personnel do an adequate level of testing to determine that the program continues to work as intended and achieves management’s application control objectives.</td>
</tr>
<tr>
<td>5. Program implementation. Program implementation controls should ensure that changes are implemented in a live environment only after adequate testing and obtaining the necessary business user management approvals.</td>
</tr>
<tr>
<td>6. Documentation and training. Documentation and training controls should ensure that end user and IT support documentation and training is updated concurrently with implementation of program changes.</td>
</tr>
<tr>
<td>7. Segregation of duties. Segregation of duties controls should ensure that the roles and responsibilities throughout the program change process have been appropriately restricted and segregated.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Access to programs and data</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Management of security activities. A security function and related policies and procedures should be designed and implemented to support the information integrity objectives of the entity.</td>
</tr>
<tr>
<td>2. Security administration. Security administration activities should ensure that access to applications, data and operating systems is appropriately restricted to only authorized individuals whose access rights are commensurate with their job responsibilities and with management’s control objectives.</td>
</tr>
<tr>
<td>3. Data security. Data security controls should ensure that direct access to data is limited to appropriate authorized individuals and is monitored for potential unauthorized activity.</td>
</tr>
<tr>
<td>4. Operating system security. Operating system security controls should ensure that operating system access is limited to appropriate authorized individuals and is monitored for potential unauthorized activity.</td>
</tr>
<tr>
<td>5. Network security. Internal and external network security controls might be necessary to protect financially significant systems from unauthorized access.</td>
</tr>
<tr>
<td>6. Physical security. Physical security controls might be necessary in certain environments to ensure that an organization’s systems are protected from unauthorized physical access. If relevant, consider how management ensures physical access is restricted for facilities that provide logical access to financially significant systems.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Computer operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Overall management of computer operations activities. Management should establish processes for controlling computer operations and monitor the effectiveness of those processes.</td>
</tr>
<tr>
<td>2. Batch scheduling and processing. Batch scheduling and processing controls should ensure that authorized production jobs are appropriately scheduled and monitored, and that exceptions are resolved completely and accurately in support of management’s application control objectives.</td>
</tr>
<tr>
<td>3. Real-time processing. Real-time processing controls should ensure that the ongoing transmission and recording of transaction data occurs completely and accurately in support of management’s application control objectives.</td>
</tr>
<tr>
<td>4. Backup and problem management. Backup and recovery controls should ensure that backup requirements are defined so that data is available when needed, problems requiring resolution are identified in a timely manner and recovery from those problems is performed completely and accurately.</td>
</tr>
<tr>
<td>5. Disaster recovery. Disaster recovery controls are important operational controls that help to ensure that an organization will be able to continue operations in the event of a disaster. Evaluate and validate these controls only if disaster recovery is considered relevant because of territory regulatory requirements and/or significant impact on ongoing concern issues.</td>
</tr>
</tbody>
</table>
Exhibit 6.2 – IT General Controls Linkage

Example – Linkage of Automated Application Controls to ITGCs

Automated application controls are controls designed into computer applications to help achieve information processing objectives. For example, many applications include a number of edit checks to help ensure that input data are accurate. These edit checks might include format checks (i.e., date or number), existence checks (i.e., customer number exists on customer master file) or reasonableness checks (i.e., maximum payment amount). When an input data element fails an edit check, that element may be rejected or it may be pulled into an application-generated exception report for subsequent follow up and resolution.

If ITGC weaknesses are noted in the computing environment supporting an application with key edit checks, it may not be possible to rely on those edit checks continuing to operate as intended. For example, a program change deficiency could result in an unauthorized change to the programming logic that checks the format of an input data field, allowing inaccurate data into the application. Furthermore, a deficiency related to security and access rights could allow inappropriate bypassing of a reasonableness check that would otherwise prevent the processing of payments in excess of a maximum tolerable threshold.

Example – Linkage of Automated Accounting Procedures to ITGCs

Automated accounting procedures are calculations, classifications, estimates or other accounting procedures performed by a computer application instead of a person. For example, an investment accounting application may be programmed to calculate market value for different types of investments according to the business rules for that type of investment. A transfer agency system may automatically calculate with-holding tax on the redemption of shares from an LSIF. A fund accounting system may calculate the accrual of management fees based on the fund value and class of units.

ITGC weaknesses may affect the reliability of such automated accounting procedures. For example, if crucial program development controls are missing, it may be difficult, without substantively validating a calculation, to establish whether management has adequately tested that an automated accounting procedure works as intended. As another example, control weaknesses that permit unauthorized program access could provide the opportunity for management to override the results of automated accounting procedures.

Example – Linkage of Application-Generated Reports to ITGCs

Application-generated reports are often used in the execution of a manual control, including business performance reviews. To assess the effectiveness of manual controls that use application-generated reports, it is necessary to understand the effectiveness of ITGCs related to the computing environment that produces the reports and protects the data that feeds them. One example of such a control is a completeness control that involves the use of pre-numbered documents. As transactions are input, missing and duplicate document numbers are identified and pulled into an exception report for follow up and resolution.

To verify this control, a user may receive a report of all missing or duplicate items used in support of a key account reconciliation. Weaknesses in computer operations may have an impact on our ability to rely on the reconciliation control because the integrity of the data being used is in question. For example, weak batch processing controls may result in use of the wrong input file, which could potentially lead to inaccurate presentation of missing or duplicate documents in the exception report. In addition, program change weaknesses could result in unauthorized or unintended changes to the programming logic, resulting in exceptions not being accurately reflected in the report.
Exhibit 6.3 – Information Processing Objectives – Detailed Considerations and Examples

For financial reporting, information processing objectives are used to identify relevant risks in a transaction flow where there should be effective management control activities.

### Completeness

Completeness is one of the most fundamental concepts governing transaction processing. When implementing controls to achieve the completeness information processing objective, management is concerned with ensuring that:

- all transactions that occur are entered and accepted once and only once for processing;
- the system identifies and rejects all duplicate items; and
- all exceptions are addressed and resolved.

Common control techniques used to achieve the completeness information processing objective include:

- batch totaling,
- sequence checking,
- computer matching, and
- one-for-one checking.

Each of these control techniques is described further in the table below.

<table>
<thead>
<tr>
<th>Control Technique</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Batch totaling</td>
<td>Transactions are grouped (batched) and counted. After input and processing, the total number of transactions processed is compared to the initial batch total. Exceptions are reported to management for resolution.</td>
</tr>
<tr>
<td>Sequence checking</td>
<td>Transactions are expected to be input and/or processed in sequential order. Missing or duplicate sequence numbers are reported to management for resolution.</td>
</tr>
<tr>
<td>Computer matching</td>
<td>Each record entered for processing is compared to a control file. Unmatched records are reported to management for resolution. A good example of this control technique is time sheet processing, where one and only one time sheet is expected for each employee.</td>
</tr>
<tr>
<td>One-for-one checking</td>
<td>Source documents are compared to a report of transactions processed to ensure that every transaction was processed once and only once. For example, investment purchases and redemptions entered into the system are matched to a trade blotter. This control technique is typically costly and time consuming, but may be used in low-volume, high-dollar processing situations.</td>
</tr>
</tbody>
</table>

Each one of these completeness control techniques requires active management review and resolution of exceptions for the control to be operating effectively.
Exhibit 6.3 – Information Processing Objectives – Detailed Considerations and Examples (cont.)

Accuracy

While completeness deals with making sure that every transaction record is processed once and only once in its entirety, the accuracy information processing objective is concerned with the individual data elements contained in each transaction being processed. In other words, within each transaction, all key data elements are input and recorded correctly. Accuracy is also of particular importance when making changes to standing data.

Certain completeness control techniques may also provide management with comfort over the accuracy information processing objective, depending on how a control is designed. This is true for the batch totalling, computer matching and one-for-one checking techniques. Programmed edit checks constitute one common control technique often used to achieve the accuracy information processing objective.

Programmed edit checks are procedures a system performs to check data in an on-line entry screen or during processing. While we generally think of edit checks in an on-line environment, they are an important aspect of control in batch processing as well. Below is a summary of some common accuracy control techniques.

<table>
<thead>
<tr>
<th>Reasonableness check</th>
<th>Ensures that data falls within predetermined limits. For example, a system rejects a transaction with a quantity of 1,001 when a quantity between 1 and 1,000 is expected.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependency check</td>
<td>Ensures that the relationship among data elements is logical. For example, if you enter an address for Ontario, the postal code you enter must be a valid postal code for Ontario.</td>
</tr>
<tr>
<td>Existence check</td>
<td>Data is compared to a file of data for that field. This technique is often used to ensure accurate entry of customer or broker account numbers.</td>
</tr>
<tr>
<td>Format check</td>
<td>Ensures that the data entered follows the expected alphanumeric patterns. For example, the system rejects a numeric data element when it is expecting only alphabetic characters.</td>
</tr>
<tr>
<td>Mathematical accuracy check</td>
<td>Ensures the accuracy of mathematical calculations performed on entered data. For example, a system requires a user to enter a unit price, quantity and extended price. The system then recalculates the extended price and rejects the transaction if the result does not match the entered extended price.</td>
</tr>
<tr>
<td>Check digit verification</td>
<td>The last digit of a reference number has a mathematical relationship to the preceding digits. If this relationship does not hold true, the transaction is rejected.</td>
</tr>
<tr>
<td>Prior data matching</td>
<td>Comparison to existing data ensures that the correct data element is being updated. Password changes often employ this technique.</td>
</tr>
<tr>
<td>Pre-recorded input</td>
<td>The correct data element is chosen from data already recorded on the system. Drop down boxes in client-server applications are a good example of this control technique.</td>
</tr>
<tr>
<td>Key verification</td>
<td>An independent party re-keys the data to ensure that the initial input was accurate.</td>
</tr>
</tbody>
</table>

Programmed edit checks are critical in real-time processing environments. Because transactions are recorded as entered, most real-time systems do not accept a transaction for processing until all edit checks have been passed.

Many programmed edit checks are set up via “configurable settings” in the application. How the settings within the application are configured and who has the ability to modify them may have an important impact on the effectiveness of these accuracy controls.
### Validity

Controls should exist to ensure that the transactions recorded in financial systems deal with actual authorized economic events related to the company. To ensure that all transactions entered and processed are valid, management may employ the following control techniques:

- manual authorization;
- application security authorization;
- programmed validity checks;
- one-for-one checking.

These techniques are described in more detail in the table below.

<table>
<thead>
<tr>
<th>Manual authorization</th>
<th>An appropriate member of management reviews and approves the validity of each transaction. This review and approval is manually recorded (e.g., the input of fund distribution rates).</th>
</tr>
</thead>
<tbody>
<tr>
<td>Application security authorization</td>
<td>The validity of each transaction is established based on the fact that it is entered or approved in the application by an authorized individual. The application is designed to ensure that transactions can only be entered in accordance with management’s intentions. Note that the effectiveness of application security controls often relies on the effectiveness of the security administration controls considered in the evaluation of Information Technology General Controls.</td>
</tr>
<tr>
<td>Programmed validity checks</td>
<td>An application may be programmed to check the validity of a transaction.</td>
</tr>
<tr>
<td>One-for-one checking</td>
<td>Manual authorization could be checked on source documents when executing this control for purposes of achieving the completeness and/or accuracy information processing objectives.</td>
</tr>
</tbody>
</table>

### Restricted access

Once valid data is recorded completely and accurately, management should have controls in place to ensure that the data remains complete, accurate and valid until amended through subsequent authorized means.

There are several techniques that management can implement to either prevent or detect unauthorized changes to recorded data, including:

- data security controls;
- file reconciliations;
- exception reports;
- detailed checking of data on file.

Each of these control techniques is described in more detail below. Note that it is unlikely that the restricted access information processing objective could be achieved in a complex system environment without the existence of effective preventative data security controls.

| Data security | Most business data is stored in some type of data environment (i.e., a data file or database). While data security controls are typically considered as part of our assessment of Information Technology General Controls, it is important that we draw the appropriate linkage from that testing to where that comfort helps us achieve the restricted access information processing objectives for specific business processes. |
| File reconciliations | Management may regularly reconcile file totals with an independently maintained control total to ensure that unauthorized changes have not occurred. This control total might be maintained manually, it might be maintained as part of the data file, or it might be maintained as part of an independent data file (e.g., a reconciliation of number of units in issue to the number of units in issue the prior day – as used in the calculation of the NAV – plus the day’s net purchases and redemptions). |
| Exception reporting | A number of the completeness, accuracy and validity techniques described above also utilize this control technique. This technique can be used to identify potential problems with the integrity of data that require management review and resolution. For example, a report of all standing data elements (e.g., management fee accrual rates) changed from one period to the next may be reviewed to ensure that no unauthorized changes were made to a master file. |
| Detailed checking of data on file | Certain data elements, especially significant data elements used in key calculations, are so important that management may determine that periodic reviews of those data elements are necessary to achieve the company’s information processing objectives. For example, the loan amortization table used to calculate customer payments in a loan system is crucial for ensuring accurate loan payment amounts. For this reason, management may periodically review the data in this table to ensure it remains accurate over time. |
Chapter 1 introduced the concept of an integrated risk/control framework separated into four broad areas – nature of business, governance, operations and compliance. Chapters 7 and 8 address the fourth part of the Investment Fund Risk/Control Framework, which is reproduced below. This chapter examines investment fund compliance associated with legal and regulatory requirements, industry practices and taxation.

### Investment Fund Risk / Control Framework

#### Part 4 - Compliance

<table>
<thead>
<tr>
<th>Legal and Regulatory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry Practices</td>
</tr>
<tr>
<td>Taxation</td>
</tr>
<tr>
<td>Assurance Reports</td>
</tr>
</tbody>
</table>

An investment fund’s principal objectives with regard to legal and regulatory requirements, industry practices and taxation are to ensure that:

- the compliance function is well defined (for example, policies and procedures);
- responsibility is delegated to an appropriate individual or group;
- adequate resources are dedicated to the compliance function (for example, support staff, education and training and supervision).

The key risk elements are as follows:

- legal and regulatory encompass investment objectives and restrictions, asset valuation and daily pricing, safeguarding of assets, reporting and continuous disclosure, and sales practices;
- industry practices address generally accepted accounting principles, and the guidelines established by the Investment Funds Institute of Canada (IFIC), Alternative Investment Management Association (AIMA) and CFA Institute (CFAI);
- taxation encompasses unit trusts, mutual fund trusts and corporations, and partnerships.

### LEGAL AND REGULATORY ISSUES

Although specific regulations may vary from fund to fund and jurisdiction to jurisdiction, for this overview, several reference sources were considered representative of all Canadian jurisdictions.

Investment funds must comply with all relevant legal and regulatory requirements. For purposes of this research report, however, the following matters merit particular attention:

- investment objectives and restrictions;
- asset valuation and daily pricing;
- reporting and continuous disclosure;
- sales practices;
- safeguarding of assets;
- outraged of assets.

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34 Proposed NI 31-103 introduces a new category of registration “investment fund manager” and new individual categories of registration: the Ultimate Designated Person (UDP) and the Chief Compliance Officer (CCO).

35 The reference sources considered representative of all Canadian jurisdictions are as follows:

- Canadian Securities Administrators (CSA)
  - National Instrument 81-106 and Companion Policy 81-106CP Investment Fund Continuous Disclosure
  - National Instrument 81-107 Independent Review Committee for Investment Funds
  - Proposed National Instrument 31-103 Registration Requirements and Proposed Framework 81-406 Point of Sale Disclosure for Mutual Funds and Segregated Funds (still in the comment phase) should also be taken into consideration.

- Ontario Securities Act and Regulations, in particular Regulation 1015, Part IV, Mutual Funds.
• safeguarding of assets;
• reporting and continuous disclosure;
• sales practices; and
• fund manager registration.

Additional requirements or constraints may be imposed by a fund’s constating and continuous disclosure documents.

**Investment Objectives and Restrictions**

An investment fund’s portfolio usually comprises virtually all of its assets. The composition of that portfolio depends primarily on the fund’s investment objectives. The objectives and the strategies to achieve those objectives are disclosed in the fund’s constating documents, as well as in the management report of fund performance, annual information form, prospectus or offering memoranda.36

A fund’s investment practices and portfolio composition may be restricted by the fund’s stated investment objectives, securities regulations and taxation laws (discussed later in this chapter).

**Investment objectives**

NI 81-102 states that the “fundamental investment objectives” of a mutual fund define both the fund’s nature and the investment features that distinguish it from other funds. According to NI 81-101, a mutual fund must have a “fundamental investment objective,” which must be described in the fund’s prospectus, along with the investment strategies that will be followed in attempting to achieve the investment objective. The prospectus must also disclose what risks apply to an investment in the fund,37 a description of the characteristics of the investor for whom the fund may or may not be suitable and how the income of the fund will be distributed.

A mutual fund cannot change its fundamental investment objective without first obtaining investor approval.38 The prospectus for the mutual fund must also be amended to disclose the prospective change (before a meeting) and the change (after the meeting). Investment strategies aimed at achieving a fundamental investment objective may be changed as needed, provided appropriate prospectus disclosure is made by amendments to the current prospectus.

**Investment restrictions**

NI 81-102 (Part 2) sets out a number of restrictions for mutual fund investments. For example, mutual funds may not invest more than 10% of their net assets in the securities of any one issuer (other than Canadian or US government securities) and may not invest more than 10% of net assets in illiquid/restricted securities. Securities legislation restricts a group of mutual funds under common management from investing/holding (collectively) more than 20% of the voting securities of an issuer (for example, s. 111(2)(b) of the Ontario Securities Act). Mutual funds may not invest with the aim of controlling or managing a particular investment.

Mutual funds may purchase and sell “specified derivatives.” The rules are designed to ensure that mutual

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36 The management discussion of fund performance in a mutual fund’s management report of fund performance should be equivalent to the corporate management discussion and analysis (MD&A), with specific modifications for investment funds. It should provide the fund manager with the opportunity to discuss the mutual fund’s position and financial results for the relevant period. The management discussion of fund performance also includes a concise summary of the mutual fund’s fundamental investment objectives and strategies and a discussion of how changes to the mutual fund over the financial year affected the overall level of risk associated with an investment in the mutual fund.

37 IFIC published Recommendations for Fund Volatility Risk Classification, which makes recommendations to fund managers for the classification of level of investment volatility risk associated with different types of mutual funds. The recommendations in the report are guidelines only, and mutual fund managers have the discretion to classify a fund with a higher or lower volatility classification (updated as of December 31, 2006).

38 NI 81-102 (Part 5) deals with fundamental changes and sets out matters that require investor approval. NI 81-106 (Part 11) defines a “material change” and sets out the disclosure requirements.
funds are not leveraged. Mutual funds may use specified derivatives for hedging purposes, may purchase or sell over-the-counter derivatives, futures, options on futures, clearing corporation options, swaps and debt-like derivatives in enumerated circumstances and must have a cash cover equal to the exposure inherent in a particular derivative instrument. Credit risk is limited through exposure to satisfactory counterparties, and market risk is limited through restrictions on exposure to any one issuer.

In addition, mutual funds may purchase and sell derivatives only if their portfolio adviser is permitted to provide that advice to the mutual fund and meets the proficiency requirements to purchase and sell such derivative instruments. If a mutual fund intends to use derivatives, it must describe in the annual information form the policies and practices in place to manage the risks associated with the use of derivatives. This disclosure would include whether there are individuals or groups that monitor the risks independently of those who trade.

A mutual fund may borrow money as a temporary measure only for accommodation of redemptions and settlement of portfolio transactions to an aggregate total of 5% of assets. A mutual fund may not lend assets (securities or otherwise) unless it does so as part of a securities lending program that is subject to certain conditions described in NI 81-102 (Part 2). A mutual fund may engage in certain specified repurchase agreements, subject to certain conditions described in NI 81-102 (Part 2) or with approval by the securities regulators.

There are additional investment restrictions in NI 81-102 and in securities regulations generally. The fund will also need to be in compliance with its constating documents, prospectus or other offering documents. In certain circumstances, relief may be available from securities regulators from certain of the restrictions contained in NI 81-102.

**Asset Valuation and Daily Pricing**

Investment funds value their portfolio at whatever time of day and frequency their governing body has established. Although some may value their securities infrequently, most investment funds value their securities every day. The valuations are used for determining a fund’s NAV per security (which is crucial to all investors because it provides an ongoing basis for effecting sale and redemption transactions at appropriate prices) and the calculation of performance.

Part 14 of National Instrument 81-106, *Investment Fund Continuous Disclosure* (NI 81-106), which was revised effective September 8, 2008, sets out requirements for the frequency and currency of the calculation of a mutual fund’s NAV. NI 81-106 requires fund managers to fair value assets and liabilities. This results in mutual funds having two different values assigned to net assets: one for financial statements which are prepared according to Canadian GAAP (“Net Asset Value”), and another for all other purposes, including unit pricing which forms the transactional basis for subscriptions and redemptions (“NAV per security”).

The NAV per security must be determined at least once each week (although mutual funds that use specified derivatives must do so every day, and mutual funds that calculate net asset value once a month and were established prior to the effective date of NI 81-106 can

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39 National Policy No. 29, *Mortgage Mutual Funds*, provides certain exceptions for mortgage mutual funds. To the extent that borrowing is permitted, a mutual fund may pledge assets (generally, the pledging of assets or granting of security interest is not permitted unless it is needed to transact in derivative instruments).

40 Short selling, other than in transactions in specified derivatives for hedging and non-hedging purposes, is not permitted. Under certain conditions, however, the securities regulators have granted approval for doing so.
continue to do so). Generally, valuation procedures are established in a fund’s constating documents. Securities of a mutual fund are sold and redeemed at “next determined” NAV per security (i.e., the transactional amount is determined by reference to the NAV per security established at the next pricing date).

In addition, portfolio transactions and sales and redemptions of the mutual fund’s securities must be reflected in the next NAV per security calculation. However, for practical purposes, most fund companies reflect such transactions on the following business day. The basis for valuing a fund’s assets must be disclosed, and investor approval is required to decrease the timing of the NAV per security calculation. National Policy No. 29, Mortgage Mutual Funds, sets out specific rules for the valuation of mortgages. Labour-sponsored funds are required to use independent valuations to provide an opinion on the value of the net assets to the securities commission.

A central feature of open-end mutual funds is that they are redeemable on demand. Investors have the right to sell their units back to the fund at the then current net asset value of the fund. The redemption price is to be paid to investors within a specified period of time following the NAV per security calculation. Mutual funds may suspend the right to redeem in certain circumstances (generally, when the primary stock exchange is not trading) with the consent of the securities regulators. A mutual fund will not accept orders for the purchase of units during any period when the redemption of units has been suspended.

Alternative investment funds are often not valued on a daily basis. The underlying assets may be difficult to price or difficult to price frequently, hence valuations tend to be on a monthly or even quarterly basis. Redemptions tend to follow the frequency of valuations for getting out of the fund. Full and partial redemptions may be treated differently in terms of the speed of the payout. Partial redemptions tend to be redeemed more quickly; for full redemptions, a staged redemption process may apply, often to allow the fund to undergo an audit prior to final payment of proceeds. Like mutual funds, valuation procedures as well as redemption and subscription processes are generally established in the fund’s constating documents. Unlike mutual funds, these types of funds are not redeemable on demand and often require prolonged notice periods prior to the effective redemption date.

**Safeguarding of Assets**

**Custodianship of portfolio assets**

NI 81-102 (Part 6) sets out regulatory requirements for the custodianship of portfolio assets. As noted in Chapter 4, the custodian may be an independent third party or directly related to the manager, but is usually a financial institution, such as a bank or a trust company, or its affiliate.

The standard of care prescribed by NI 81-102 is designed to protect a mutual fund from loss in the event of the insolvency of those holding its portfolio assets. It may require custodians and sub-custodians to take additional steps to properly protect a mutual fund’s portfolio assets, for example, in a foreign jurisdiction, and to ensure that those portfolio assets are unavailable to satisfy the claims of creditors of the custodian or sub-custodian, having regard to creditor protection and bankruptcy legislation of any foreign jurisdiction in which portfolio assets may be located. At least annually, the custodian must report to the mutual fund and to securities regulators on compliance with NI 81-102 requirements.

**Trust accounts**

NI 81-102 (Part 11) requires principal distributors and participating dealers to account separately for money
they may receive for the sale of, or on the redemption of, mutual fund securities. They are prohibited from commingling any money received with their other assets or with money held for the purchase or received on the sale of other types of securities. This means that dealers may not deposit into the trust accounts money obtained from the purchase or sale of other types of securities, such as guaranteed investment certificates, government treasury bills, segregated funds, bonds or equity securities.

Furthermore, they may not use any money received for an investment in mutual fund securities to finance their own operations. (Appendix G presents illustrative compliance reports and auditors' reports that must be completed by mutual funds, principal distributors and participating dealers regarding Part 11 of NI 81-102.)

Any costs associated with returned client cheques that did not have sufficient funds to cover a trade are a cost of doing business and should be borne by the applicable principal distributor or participating dealer, and should not be offset by interest income earned on the trust accounts. The requirements also state that trust accounts may not incur overdraft positions. To prevent the practice of “lapping,” NI 81-102 prescribes the circumstances under which a principal distributor or participating dealer may withdraw funds from the trust accounts. Interest earned on money held in the trust accounts must be paid to the applicable mutual fund or its investors “pro rata based on cash flow.” This requirement means, in effect, that the applicable mutual fund or investor should be paid the amount of interest that it would have received had the money held in trust been the only money held in that trust account.

**Reporting and Continuous Disclosure**

Various continuous disclosure documents are prepared for mutual funds. Generally, NI 81-106 requires that annual audited financial statements, interim unaudited financial statements (Part 2), annual and interim management reports of fund performance (Part 4), reports of material changes (Part 11), press releases and, if meetings of investors have been called, proxy and information circulars (Part 12), must be filed with securities regulators and delivered to investors. Material change reports and press releases are not mailed out to investors; they are filed and released through a newswire and posted on the website of the mutual fund or mutual fund manager.

Additional disclosure documents for a mutual fund that must be prepared and made available to investors on request are: quarterly portfolio disclosure (NI 81-106, Part 6), proxy voting policy and proxy voting record (Part 10). There is no requirement to file these documents with securities regulators but these documents are to be posted on the website of the mutual fund.

Independent Review Committee (IRC) reports to investors must be filed with securities regulators, displayed on the homepage of the mutual fund website and made available to investors on request.

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41 NI 81-102 (Part 11) provides an exemption from the trust account rules for members of the Investment Industry Regulatory Organization of Canada.

42 Certain MFDA firms have been granted relief from the requirements of Section 11.1(1)(b) and Section 11.2(1)(b) of NI 81-102 to permit commingling of cash received for the purchase or redemption of mutual fund securities with cash received for the purchase and sale of other securities or instruments.

43 One of the three significant deficiencies identified in the compliance reviews of fund managers in OSC Staff Notice 33-731 related to the use of trust accounts. About 27% of fund managers had significant deficiencies in this area. The OSC found that accounts were not labelled as “trust accounts,” accounts were non-interest bearing, interest earned in the account was not allocated to funds pro-rata based on cash flow, accounts were in an overdraft position and commingling of operating monies in the accounts.

44 NI 81-106 gives the mutual fund choices for the delivery of financial statements and management reports of fund performance. A mutual fund can send these documents to all investors or obtain instructions from investors as to what documents they wish to receive. When soliciting delivery instructions from an investor, a mutual fund can deem no response from the investor to be a request to receive all, some or none of the documents.
Annual and interim financial statements and annual and interim management reports of fund performance must be approved by the mutual fund’s trustee(s) — for a mutual fund trust — or the board of directors — for a mutual fund corporation — before these documents are filed with securities regulators and made available to investors (NI 81-106, Part 2).

NI 81-106 (Part 2) requires that the annual financial statements, auditor’s report and the annual management reports of fund performance must be filed on or before the 90th day after the mutual fund’s most recently completed financial year. Further, the regulation requires that the interim financial statements and the interim management reports of fund performance must be filed on or before the 60th day after the end of the most recent interim period of the mutual fund.

NI 81-101 (Part 3) states that the following documents are to be incorporated by reference (by adding a list of the documents involved) and form part of a mutual fund’s simplified prospectus:

- the annual information form that is filed concurrently with the simplified prospectus;
- the most recently filed comparative annual financial statements, together with the accompanying report of the auditor, filed either before or after the date of the simplified prospectus;
- the most recently filed interim financial statements that were filed before or after the date of the prospectus and that pertain to a period after the period to which the annual financial statements then incorporated by reference in the simplified prospectus pertain;
- the most recently filed annual management report of fund performance that was filed before or after the date of the simplified prospectus and that pertains to a period after the period to which the annual management report of fund performance then incorporated by reference in the simplified prospectus pertains.

NI 81-106 (Part 2) requires that the financial statements of a mutual fund must be prepared in accordance with Canadian GAAP. Certain sections of the management report of fund performance will reference “net assets” as presented in the financial statements, while all other calculations will be made using net asset value as defined by NI 81-106 (Part 14).

The annual and interim management reports of fund performance disclose a mutual fund’s management expense ratio and trading expense ratio and how these ratios are calculated. These ratios are annualized where the fiscal period is less than one year. The effect of any changes to the basis of the management fee calculation should also be disclosed. Information on the management expense ratio is also disclosed in the mutual fund’s simplified prospectus and in the proposed point of sale disclosure document.

Details of all fees and expenses borne by the fund, as well as any waivers, whether voluntary or required by regulation, should be considered for disclosure in the financial statements in accordance with the appropriate regulations and Canadian GAAP. Additional disclosures may be required, for example, about the NAV per security of the fund, securities lending and about specified derivatives. Details on the required financial statement disclosures are in NI 81-106 (Part 3).

**Sales Practices**

NI 81-102 (Parts 9, 10 and 18) sets out regulatory requirements for sales and redemptions of mutual fund

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45 The trading expense ratio represents total commissions and other portfolio transaction costs of an investment fund expressed as an annualized percentage of daily average net asset value during the period (see Part B, section 3.1, item (1) of Form 81-106F1).

46 NI 81-106 (Part 15) prescribes the method for calculating the management expense ratio and fund-of-funds expenses, if any.
securities and also calls for appropriate investor records to be maintained. The regulations are intended to ensure that:

• a mutual fund promptly receives an investors’ money;
• the opportunity for losing an investors’ money before it is invested in the mutual fund is minimized; and
• the mutual fund or the appropriate investor receives all interest that accrues on money during the periods between the time an investor delivers the money and the time that money is invested in the mutual fund (in the case of sales of mutual fund securities), or between the time a mutual fund pays out money and the time the investor receives it (in the case of redemptions).

NI 81-102 (Part 15) establishes regulatory requirements for sales communications and prohibited representations. Mutual fund advertising must not be misleading, must not conflict with the prospectus and must not distort information contained in the prospectus. It must also comply with certain standards for use of performance information (that is, it must disclose 1, 3, 5 and 10-year returns if any performance information is to be used; performance data may not be used in radio and television advertisements). NI 81-102 sets out the complete code for mutual fund sales communications, including the method of calculating the applicable performance returns. In addition, the name of the dealer making any particular advertisement must be disclosed in the sales communication. Securities can be marketed only through registered dealers or brokers.

NI 81-105, Mutual Fund Sales Practices, regulates sales practices and establishes a minimum standard of conduct for industry participants. Rules prohibit managers (and related parties) of mutual funds from paying money, providing nonmonetary benefits and reimbursing costs to dealers in connection with the distribution of securities of the mutual fund other than as specifically permitted. NI 81-105 permits the payment of specified commissions, certain cooperative marketing payments, certain sharing of educational costs and general business promotion (all within the limits established). NI 81-105 also deals with practices such as reciprocal commissions, tied selling, commission rebates (defined as payments to investors to cover redemption fees incurred in redeeming out of one fund to go into a different managers’ funds), financial assistance, charitable donations, disclosure of equity interests between dealers and managers, disclosure of sales practices followed and compensation paid to dealers. NI 81-105 primarily regulates the relationship between fund managers and participating dealers.

If fund managers are to meet their standard of care under NI 81-105, they must develop appropriate policies and procedures specific to their business and apply them consistently. Fund managers also need to maintain documentation to support their decisions to provide sponsorship under Part 5, NI 81-105.

Fund Manager Registration

Under the second version of proposed National Instrument 31-103 Registration Requirements, all registrants will be required to establish compliance and supervisory procedures, including procedures concerning

47 NI 81-105 does not regulate the relationship between a fund manager and its principal distributor, except where a principal distributor of one fund group also sells funds managed by third-party managers. In the latter case, a principal distributor cannot provide any “incentive” to its sales force to recommend the sponsored funds over a third-party fund. Other provisions in NI 81-105, such as disclosure and commission rebates and tied selling, apply to the distribution of mutual funds through principal distributors only (that is, dealers selling only sponsored mutual funds).

48 In the fall of 2006, OSC staff conducted a focused review of the marketing and educational practices of fund managers under NI 81-105(Part 5). In April 2007, the OSC published Staff Notice 11-706, Report on Mutual Fund Sales Practices Under Part 5 of NI 81-105, which summarizes the findings and provides guidance to the industry. These remarks were published in OSC Bulletin (April 27, 2007), pp 3892-3908.

49 Proposed National Instrument 31-103 Registration Requirements was published for comment on February 20, 2007 and was re-released for a second comment period on February 29, 2008 which ended on May 29, 2008.
management of conflicts of interest and, in most cases, complaint handling. Detailed guidelines are given to registrants seeking to comply with these requirements. The compliance requirements and guidelines will apply, with two exceptions, uniformly to all registered dealers, advisers and fund managers.

The CSA purposefully propose “principles-based” rules to mandate compliance systems. The rules proposed in NI 31-103 are supplemented by guidelines in the proposed companion policy to NI 31-103 outlining how registered firms should implement an effective compliance system, as well as the CSA’s views about the elements of an effective compliance system.

The proposals in NI 31-103 concerning compliance, supervision and management of conflicts of interest are generally new articulations of existing regulatory concepts. Proposed NI 31-103 also contains new concepts, such as requirements that registered firms implement policies and procedures designed to address client complaints. A registered firm will be required to document all complaints made, or legal actions or other dispute resolution proceedings commenced against the firm and its representatives. A registered firm also will be required to respond “effectively and fairly” to any complaints in a timely manner.50 Registrants will be required to participate in a dispute resolution service.

A registered firm will be required to establish and enforce a system of controls and supervision that is designed to achieve the firm’s, and all individuals acting on its behalf, compliance with all applicable securities laws, as well as manage the business risks faced by the firm in accordance with “prudent business practices.”51 This system of controls will be required to be documented in the form of written policies and procedures, although the CSA emphasize that “policies and procedures in themselves do not constitute an effective compliance system.” An effective compliance system is one that in practice achieves reasonable assurance that all regulatory requirements are being met in a timely and on-going fashion.

**Ultimate Designated Person**

All registered firms will be required to have an ultimate designated person (“UDP”) who will be responsible to supervise compliance activities, as well as promote compliance within the firm. The UDP must be the CEO or equivalent of the firm. Each registered firm will also be required to appoint an officer or partner as the chief compliance officer (CCO); this individual can also be the UDP, as appropriate. The CCO must be registered with the applicable securities commissions in that capacity and must meet specified proficiency requirements, which are generally tailored to the specific category of registration.52

Proposed NI 31-103 articulates the expected functions of a CCO, which include submitting an annual report to the registered firm’s board of directors for the purpose of “assessing compliance” by the firm and the individuals acting on its behalf, with securities legislation. The UDP and CCO must have direct access to the firm’s board of directors at such times as either of them may independently deem necessary. The CSA emphasize in the companion policy to proposed NI 31-103 that compliance is not the sole responsibility of the UDP or the CCO or a designated individual in a firm but rather it is a firm-wide responsibility. According to the CSA, a

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50 The CSA has suggested that firms acknowledge receipt of complaints within 10 days and provide a substantive response within 3 months.

51 The requirements for complaint handling systems will not apply to registered investment fund managers or to exempt market dealers in respect of their “permitted” clients (a sub-category of super accredited investors).

52 Individuals registered as CCO’s for a registered firm prior to enacting NI 31-103 and who apply for registration within one month of NI 31-103 coming into force, will be grandfathered and will not be required to meet any new proficiency requirements for CCOs in that category.
registered firm’s compliance system should achieve each of the following objectives:

• It should ensure that everyone in the firm, including the board of directors, partners, management, employees and agents (whether or not they themselves registered) understands the standards of conduct applicable to their designated roles.
• It should be reasonably likely to identify non-compliance at an early stage.
• It should provide effective mechanisms for the timely correction of non-compliant conduct.

A registered firm, when setting up its compliance systems, will be encouraged to consider its size, scope of operations, products, types of clients and risks, along with other relevant factors. The CSA explain that an effective compliance system has two inter-related elements: day-to-day supervision and systematic monitoring.

A registered firm will also be required to ensure that its compliance monitoring and supervision policies and procedures take into account conflicts of interest management issues. Proposed NI 31-103 describes four areas where a registered firm must identify and address any potential or actual conflict of interests: (1) within the registered firm; (2) with other entities; (3) with a client; and (4) between clients.

Each registrant will be required to have a written policy which sets out policies and procedures on how it deals with conflicts of interests in a fair, equitable and transparent manner exercising responsible business judgment influenced only by the best interests of its client(s). The CSA suggest that registrants can avoid, control and/or disclose conflicts of interest in order to comply with proposed NI 31-103. The CSA have clarified that fund managers need only comply with National Instrument 81-107 with respect to conflicts of interest associated with the management of publicly offered investment funds, by granting an exemption from certain of the conflict provisions provided for in proposed NI 31-103.

Supervisory personnel will be required to, among other things, take all reasonable measures to ensure that registered individuals comply with applicable standards of care and securities regulation and maintain an appropriate level of proficiency on an on-going basis. Emphasis is also placed in the proposed companion policy to NI 31-103 on the CSA’s expectations for registered firms’ monitoring of service providers, including due diligence and on-going monitoring of service quality.

Objectives, Risks and Control Measures

An investment fund’s principal objectives are to ensure that the compliance function is well defined, responsibility is delegated to an appropriate individual or group, and adequate resources are provided. Failure to comply with the legal and regulatory requirements can have serious consequences. The potential impact on a fund violating legal and regulatory requirements will depend on the nature of the violation, the period over which the violation occurred and the resulting loss, if any. In some cases, a violation may result in reputational damage or in litigation between the investors and the investment adviser/fund manager. Violations of regulatory restrictions can be more serious as they could trigger sanctions such as a cease trading order, which would prevent the fund from being bought or sold.

For these reasons, the Study Group maintains that management should establish policies and procedures to ensure that a fund complies with all legal and regulatory requirements throughout the year, including:

• training designated individuals to understand the legal and regulatory requirements so that they can adhere to them;
• training designated individuals to independently monitor compliance of operations staff;
• implementing systems and procedures to identify, isolate and inform management of violations on a timely basis; and
Exhibit 7.1 presents control measures for assessing compliance with legal and regulatory requirements.

### Exhibit 7.1

<table>
<thead>
<tr>
<th>Control Measures for Assessing Compliance with Legal and Regulatory Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Policies, procedures and monitoring</strong> - Consider what overall approach management has established to ensure compliance with legal and regulatory requirements. What policies and procedures are in place? Are they appropriately documented? How are the policies generally applied?</td>
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<tr>
<td>• Do controls exist to ensure compliance with fund specific requirements?</td>
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<tr>
<td>• How are special circumstances dealt with and new risks and control requirements identified?</td>
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<tr>
<td>• Do individuals responsible for compliance have the necessary capability (for example, knowledge, skills, technology, budget) and independence, and are they properly supervised?</td>
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<td>• Does management review reports that track compliance with the various regulations and follow up on violations on a timely basis?</td>
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<tr>
<td><strong>B. Investment transactions</strong> - Consider whether management is familiar with the restrictions set out by the offering document and regulatory bodies, including recent changes.</td>
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<td>• Does management review investment transactions for compliance?</td>
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<tr>
<td>• Is consideration given to the regulatory requirements and the fund’s prospectus with respect to the method of accounting and classification of income earned?</td>
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<tr>
<td>• Does the information system highlight transactions or balances that exceed specified limits related to regulatory or other restrictions? Is the system updated to reflect changes in regulatory limits?</td>
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<tr>
<td><strong>C. Sales and redemptions</strong> - Consider whether management is aware of the regulatory requirements relating to sales and redemptions, for example:</td>
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<tr>
<td>• Are orders for sales or redemptions transmitted to the office of the principal distributor for the fund within the period specified in the regulations?</td>
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<tr>
<td>• Is payment of the issue price for sales made to the principal distributor of the fund within the period specified in the regulations?</td>
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<tr>
<td>• Are sales and redemption orders processed within the specified period?</td>
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<tr>
<td>• Are monies received on rejected orders returned and payment of redemption proceeds made within the specified period?</td>
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<tr>
<td>• Are sales or redemption orders transacted at a price equal to the NAV of the fund as determined by regulations and/or fund specific requirements (for example, next computed NAV after receipt of the order)?</td>
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<tr>
<td>• Are sales and redemptions reflected in the computation of the next NAV after the trade date?</td>
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<tr>
<td>• Does internal audit provide an independent assessment of the effectiveness of the various controls and recommend improvements to mitigate risk?</td>
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<tr>
<td>• Is the frequency of determining the NAV for pricing purposes in accordance with regulations?</td>
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<tr>
<td>• Does mail returned undelivered result in the pertinent account being identified and monitored?</td>
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<td>• Is frequent trading monitored?</td>
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<td>• Does management monitor for large investor positions?</td>
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<tr>
<td><strong>D. Trust accounts</strong> - Consider whether controls exist to ensure the principal distributor meets the regulatory requirements that monies received for sales or redemptions are separately accounted for and deposited in a separate account (for example, an interest-bearing “trust” account). Are there controls to ensure:</td>
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<tr>
<td>• Monies are not commingled with the assets of, or used in the operations of, the principal distributor?</td>
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<tr>
<td>• Interest earned on the trust account is paid to investors or the fund on a regular basis?</td>
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<tr>
<td>• Monies received for sales are paid to the fund within the specified period?</td>
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<tr>
<td>• Monies received for redemptions are paid to the investors within the specified period?</td>
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<tr>
<td><strong>E. Shareholder/investor equity</strong> - Consider whether management maintains the fund’s reputation and the fund manager’s reputation through disclosures to key stakeholders that are appropriate, complete, accurate and timely. Are disclosures in compliance with laws and regulations? Are dividend/distribution data accurately calculated using appropriate share/unit values in accordance with approved rates and tax regulations?</td>
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</table>
Industry Practices

General practices in the investment funds industry are governed by various bodies and trade associations. For this research report, the following merit particular attention:

- Generally Accepted Accounting Principles;
- Investment Funds Institute of Canada;
- Alternative Investment Management Association;
- CFA Institute.

Generally Accepted Accounting Principles

Financial reporting encompasses more than financial reports. It may include financial information presented in many forms, for example, in a prospectus, press release, sales and marketing material, an analyst’s report and on an Internet web site. Financial statements are designed to meet the common information needs of many different external users of financial information. They are normally prepared in accordance with generally accepted accounting principles (GAAP). As well, the notes to the financial statements, and supporting schedules to which the financial statements are cross-referenced, are an integral part of the financial statements overall.

While NI 81-106 requires the financial statements of investment funds to be prepared in accordance with Canadian GAAP, National Instrument 14-101 Definitions defines Canadian GAAP. When used in securities legislation, “generally accepted accounting principles” have the meaning ascribed to this term in the Handbook of the Canadian Institute of Chartered Accountants (CICA Handbook).

Questions have been raised about whether the Recommendations set out in the CICA Handbook – Accounting adequately deal with the accounting and disclosure matters relevant to investment fund financial reporting. Nevertheless, the CICA Research Report Financial Reporting by Investment Funds issued in 2009 concludes that the financial statements of all types of investment funds should be prepared in accordance with the generally accepted accounting principles set out in the CICA Handbook – Accounting. It is anticipated that all types of investment funds will use that Research Report as supplementary guidance to the Recommendations in the CICA Handbook – Accounting.

Investment Funds Institute of Canada

The Investment Funds Institute of Canada (IFIC), founded in 1962, is the national association of the investment funds industry in Canada. Member firms currently represent most of the open-end mutual funds in the country. IFIC membership is made up of fund management companies sponsoring more than 2,000 mutual funds, dealer firms selling mutual funds and affiliates representing law, accounting and other professional firms. In 2007, IFIC’s member funds managed about $700 billion in assets.

IFIC’s responsibilities include:

- adopting a proactive advocacy stance;
- advocating for the creation and adoption of harmonized approaches, where possible, for all retail pooled investment products and by building adviser confidence in mutual fund products (IFIC primarily represents NI 81-102 products but will work to harmonize approaches across all pooled investment products, including life insurance segregated funds, pooled funds, hedge funds and exchange-traded funds (ETFs), in conjunction with the Canadian

53 "Generally accepted accounting principles" (GAAP) is the term used to describe the basis on which financial statements are normally prepared. GAAP in Canada is defined in the CICA Handbook – Accounting and discussed in the Handbook’s paragraphs 1000.59 to 1000.61.

54 Refer to CICA Handbook – Accounting, Section 1000, “Financial Statement Concepts,” paragraphs 1000.04 to 1000.06, and Section 1500, “General Standards of Financial Statement Presentation,” paragraphs 1500.03 and 1500.04.

55 CICA research studies are included as a source of reference in the CICA Handbook – Accounting discussion of what constitutes generally accepted accounting principles (paragraph 1000.60).
Securities Administrators (CSA) and related industry associations;

• providing high-quality, value-added programs and services to members;
• promoting enhanced standards and knowledge to the industry;
• positioning the industry’s workforce to meet and exceed regulated requirements;
• strengthening the public’s confidence in investment funds;
• promoting the importance of investing;
• providing timely, accurate and authoritative industry information to the public.

Alternative Investment Management Association

The Alternative Investment Management Association (AIMA) is an international, not-for-profit trade association focused on increasing investor education, transparency, due diligence and sound practices. Its aim is to also work closely with regulators and other interested parties to encourage the responsible use of alternative investments. Globally, AIMA has more than 1,100 corporate members in 46 countries. In Canada, it has more than 70 corporate members. Membership as a whole ranges from single fund managers to administrators and other service providers.

CFA Institute

Headquartered in the United States, the CFA Institute (CFAI) is a global, nonprofit association that administers the Chartered Financial Analyst® (CFA®) program worldwide. It has more than 86,000 members in 121 countries and territories, including over 75,000 CFA charterholders. The CFAI is also affiliated with 134 professional societies in 55 countries and territories. AIMR_PPS® and GIPS® standards converged effective January 1, 2006. A new governance structure followed, with the oversight of GIPS undergoing significant changes. During this period of transition, the CFA Center now functions as the Secretariat for GIPS by organizing and supporting meetings, as well as working to promote adoption and education for GIPS.

Objectives, Risks and Control Measures

An investment fund’s principal objectives are to ensure that the compliance function is well defined, responsibility is delegated to an appropriate individual or group, and adequate resources are provided. There are serious consequences to failing to comply with the relevant standards and guidelines. The potential impact on a fund violating industry practices will depend on the nature of the violation, the period over which the violation occurred and the loss, if any. In some cases, a violation may result in reputational damage or in litigation between the investors and the investment adviser/fund manager. Violations of industry practices can be more serious as they could result in sanctions by the trade associations and/or regulatory authorities, and in a qualified auditors’ report for failure to prepare financial statements in accordance with GAAP.

For these reasons, the Study Group maintains that investment fund management should establish policies and procedures to ensure that their funds remain in compliance with industry practices throughout the year, including:

• training designated individuals dealing with industry matters to understand the requirements and to adhere to them;
• implementing systems and procedures to identify, isolate and inform management of violations on a timely basis; and
• developing specific action plans to deal with violations promptly and effectively.

Control measures for assessing compliance with industry practices are presented in Exhibit 7.2.
Exhibit 7.2
Control Measures for Assessing Compliance with Industry Practices

A. Policies and procedures – Consider what overall approach management has established to ensure compliance with industry practices. What policies and procedures are in place? Are they appropriately documented? How are the policies generally applied?
• Do controls exist to ensure compliance with specific requirements?
• How are special circumstances dealt with?
• How are new risks and control requirements identified?
• Do individuals with responsibility for compliance have the necessary capability (for example, knowledge, skills, technology, budget) and independence, and are they properly supervised?

B. Monitoring – Consider whether (and how) compliance systems are monitored for effectiveness.
• Does management review reports that track compliance with the various regulations and follow up on violations on a timely basis?
• Do the responsibilities of internal audit include monitoring compliance with industry practices?

TAXATION\textsuperscript{56}
Investment funds are subject to a highly technical and complex set of statutory, judicial and administrative tax rules that are imperfect in their operation and subject to frequent change. Nevertheless, failure to comply with these rules can result in significant financial and reputational costs.

Investment funds may be structured in various ways, including unit trusts, mutual fund trusts, mutual fund corporations and partnerships. Each of these vehicles is subject to specific rules in the Income Tax Act and Income Tax Regulations. Provincial and foreign tax rules may also be relevant. A brief discussion of the basic tax regime applicable to each of these vehicles follows. Investors are increasingly aware of the tax differences between fund structures and are making investment decisions based not only on the pre-tax returns published by funds, but also on the effective after-tax return they realize.

\textsuperscript{56} The following materials provide further insight on taxation requirements for investment funds:
• PricewaterhouseCoopers LLP, “Investment Management Taxation” seminar materials.
• Investment Funds Institute of Canada, “The Taxation of Investment Income,” Canadian Investment Funds Course, Taxation Modules.

Unit Trusts and Mutual Fund Trusts
Investment funds structured as trusts are generally unitized and qualify as a “unit trust” for tax purposes. A “mutual fund trust” is a unit trust that meets certain specific requirements set out in the Income Tax Act and Income Tax Regulations. Although trusts are subject to the tax rules that apply to individuals, many special rules apply to investment trusts.

Investment trusts generally operate as conduit vehicles for tax purposes. The terms of its Declaration of Trust generally specify that an investment fund structured as a trust has to distribute sufficient amounts of income and capital gains to ensure it does not have to pay any income taxes. A trust may deduct distributions paid (or payable) to investors in calculating its net income for tax purposes. These rules result in the investor, rather than the trust, being subject to tax on the income and gains distributed. Distributions in excess of the income and capital gains of the trust are a return of capital, which is not included in the investor’s income but reduces the cost base of the investment.

The income earned by a trust may consist of one or more of the following: dividends from taxable Canadian corporations; interest income; foreign income (net of foreign withholding taxes); and net capital gains. Although income distributed by a trust does not otherwise retain its source, a trust may make certain tax designations that permit the source to be retained by the investor. For example, if the fund realizes net capital gains from the sales of securities, that income may be designated to be net capital gains in the hands of investors.

A number of tax advantages are available to unit trusts that qualify as mutual fund trusts. One of the most significant of these advantages is that a mutual fund trust may be able to retain realized capital gains and obtain a refund of income taxes on those gains (this is intended to avoid potential double taxation of the gains.
otherwise realized by the investors). Another advantage is that mutual fund trusts are not subject to Alternative Minimum Tax.

**Mutual Fund Corporations**

Mutual fund corporations are subject to the tax rules that apply to corporations generally. Whereas mutual fund trusts are conduits for all of their income and capital gains, mutual fund corporations are conduits for only dividend income from taxable Canadian corporations and net taxable capital gains. Other income, such as interest and foreign dividends, is taxed at federal and provincial corporate tax rates.

A refundable tax payable on dividend income received from taxable Canadian corporations is recoverable when the mutual fund corporation pays an equivalent amount of taxable dividends to its investors. The tax payable on realized capital gains may be refundable to a mutual fund corporation when underlying capital gains are distributed to investors, or through a rule similar to the refund mechanism for mutual fund trusts.

Mutual fund corporations may make two types of dividend payments to investors: ordinary dividends and capital gains dividends. Unlike distributions made by mutual fund trusts, a mutual fund corporation cannot deduct dividend payments for tax purposes, but may obtain a refund of any refundable taxes paid. A mutual fund corporation may also be able to make payments that are a return of capital to investors rather than a dividend. Mutual fund corporations may be subject to capital taxes.

**Partnerships**

A partnership is not a taxable entity but it is required to compute the income arising from its activities and allocate this income to the partners. The income must be included in the partners’ income even though it may not be distributed to them. Most investment vehicles using this form are structured as limited liability partnerships to protect investors from potential liability, and are subject to tax rules limiting the amount of any loss arising from the partnership that may be claimed by limited partners.

**Objectives, Risks and Control Measures**

An investment fund’s principal objectives are to ensure that the compliance function is well defined, responsibility is delegated to an appropriate individual or group, and adequate resources are provided. Failure to meet these objectives can have serious consequences. The potential impact on a fund violating taxation requirements will depend on the nature of the violation, the period over which the violation occurs and the quantum of the error. A violation could result in reputational damage or in litigation between the investors and the investment adviser or fund manager.

The complexity of the tax rules applicable to investment funds means that violations may occur. The most common violations arise from incorrect application of the tax rules, failure to identify technical issues, systems limitations and human error.

A number of risks could have a serious impact on investment funds:  
- failure to maintain the tax status of the investment fund;  
- failure to calculate the distributions correctly, which could create a hidden tax liability in the investment fund; and  
- failure in making the correct elections to ensure optimal returns for the fund and its investors.

The risk of adverse consequences arising from violations has increased for two main reasons. First, more complex and sophisticated products are being offered to investors. These products are often structured to achieve certain tax benefits, but far more planning and oversight may
be required to ensure that these benefits are realized. Second, the tax authorities are directing greater resources to the investment management industry, commensurate with its increased size and sophistication.

For these reasons, the Study Group maintains that investment fund management should establish policies and procedures to ensure that their funds remain in compliance with taxation requirements throughout the year, including:

- identifying and training designated individuals dealing with taxation matters so that they understand the requirements and manage the risks related to them;
- implementing systems and procedures to identify, isolate and inform management of violations on a timely basis; and
- developing specific action plans to deal with violations promptly and effectively.

Exhibit 7.3 outlines control measures for assessing compliance with taxation requirements.

Exhibit 7.3

<table>
<thead>
<tr>
<th>Control Measures for Assessing Compliance with Taxation Requirements</th>
</tr>
</thead>
</table>
| **A. Policies and procedures** – Consider what overall approach management has established to ensure compliance with taxation requirements. What policies and procedures are in place? Are they appropriately documented? How are the policies applied?
| • Do controls exist to ensure compliance with specific tax requirements?
| • How are special circumstances dealt with?
| • How are new risks and control requirements identified?
| • Do individuals with responsibility for tax compliance have the necessary capability (for example, knowledge, skills, technology, budget) and independence, and are they properly supervised? |
| **B. Monitoring** – Consider how tax compliance systems are monitored for effectiveness.
| • Does management review reports that track compliance with the various regulations and follow up on violations on a timely basis?
| • Do the responsibilities of internal audit include monitoring compliance with the fund’s tax requirements? |
Chapter 8

INVESTMENT FUND COMPLIANCE – Part II

Chapter 1 introduced the concept of an integrated risk/control framework separated into four broad areas – nature of business, governance, operations and compliance. Chapters 7 and 8 address the fourth part of the Investment Fund Risk/Control Framework, which is reproduced below. This chapter examines investment fund compliance regarding assurance reports.

### Investment Fund Risk / Control Framework

Part 4 - Compliance

<table>
<thead>
<tr>
<th>Legal and Regulatory</th>
<th>Industry Practices</th>
<th>Taxation</th>
<th>Assurance Reports</th>
</tr>
</thead>
</table>

For this component of the framework, the key risk elements encompass the audit of financial statements, compliance with National Instrument 81-102, prospectuses and annual reports, and other assurance services.

### AUDIT OF FINANCIAL STATEMENTS

In considering the auditor’s report on investment fund financial statements, the Study Group reviewed Canadian generally accepted auditing standards and specifically considered the Recommendations in the following sections of the *CICA Handbook – Assurance*: “Audit of Financial Statements – an Introduction” (Section 5090); “The Auditor’s Standard Report” (Section 5400); “Date of the Auditor’s Report” (Section 5405); “Reservations in the Auditor’s Report” (Section 5510); and “Other Reporting Matters” (Section 5701). In the Study Group’s view, the Recommendations in these sections apply to the audit of investment funds.

The Study Group reviewed the regulatory requirements set out in National Instrument 81-106 *Investment Fund Continuous Disclosure*, which deals with comparative financial statements and the auditor’s report. NI 81-106 requires every investment fund to which it applies to file annually, on or before the 90th day after its most recently completed financial year, comparative financial statements prepared in accordance with Canadian generally accepted accounting principles. NI 81-106 also requires that the financial statements be accompanied by an auditor’s report and be approved by the board of directors, general partner, manager or trustees of the investment fund, as applicable.

The auditor’s report must be prepared in accordance with Canadian generally accepted auditing standards, not contain a reservation, identify all financial periods for which the auditor has issued an auditor’s report and identify both the auditing standards used to conduct the audit and the accounting principles used to prepare the financial statements. For reporting issuer investment funds, the auditor’s report must cover the most recently completed financial year and, where applicable, the immediately preceding financial year.

*CICA Handbook – Assurance* Section 5400, “The Auditor’s Standard Report,” deals with the standard report of an auditor who has been engaged to express an opinion on general purpose financial statements. In the Study Group’s view, the auditor’s standard report for an investment fund should cover all financial statements required for fair presentation of net assets, results of operations, cash flows (if applicable) and changes in net assets in accordance with Canadian generally accepted accounting principles. Unaudited information, which
Assessing Risks & Controls of Investment Funds

could be construed to be part of the audited financial statements, should be clearly differentiated.

It is desirable to have a measure of uniformity in the form of the auditor’s standard report because it helps readers identify any unusual circumstances. Accordingly, the auditor’s standard report should make specific reference to an investment fund’s financial statements, which normally comprise the Statement of Net Assets, Statement of Portfolio Investments, Statement of Operations, Statement of Changes in Net Assets and, if applicable, a Statement of Cash Flows. The notes to the financial statements are an integral part of the financial statements and need not be specifically referred to in the auditor’s standard report.

The auditor’s standard report on the general purpose financial statements of an investment fund should disclose the addressee, the name of the auditor (or firm), the date of the report and the place of issue. The auditor’s report should where there has been a change in auditor, make reference to the former auditor’s report on the prior, comparative period.

For corporate class funds, the auditor’s report on each class of shares should contain a fourth paragraph indicating that the auditor has also expressed an opinion on the financial statements of the corporation. In addition, the auditor’s report on the corporation’s financial statements should contain a fourth paragraph stating that the auditor has also expressed an opinion on the financial statements of each of the classes.

Normally, an engagement letter is provided by the auditor to the investment fund in connection with the audit of the financial statements of an investment fund. To reduce the risk that either the auditor or the investment fund may misinterpret the needs or expectations of the other party, it is in the interest of both parties, preferably before the engagement commences, to establish a mutual understanding in a written agreement. The engagement letter would normally address the matters listed in Appendix B of this Research Report.

In addition, a management representation letter is normally provided to the auditor by the investment fund in connection with the audit of the financial statements of an investment fund. The written representations of management provide evidential matter that the auditor relies on in forming an audit opinion on the financial statements. Certain representations in this letter will be limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement. Matters that would be considered for inclusion in the management representation letter are listed in Appendix C of this Research Report.

**COMPLIANCE WITH NATIONAL INSTRUMENT 81-102**

National Instrument 81-102 (Part 12) deals with compliance reports. It states that a mutual fund that does not have a principal distributor has to complete and file, within 140 days after its financial year end:

- a report describing the mutual fund’s compliance during that financial year with the applicable requirements of Parts 9, 10 and 11; and
- a report by the auditor of the mutual fund.

NI 81-102 further states that the principal distributor of a mutual fund should complete and file, within 90 days after the financial year end of the principal distributor:

- a report describing compliance by the principal distributor during that financial year with the applicable requirements of Parts 9, 10 and 11; and
- a report by the auditor of the principal distributor.
According to NI 81-102, each participating dealer that distributes mutual fund securities in a financial year must complete and file, within 90 days after the end of that financial year:

- a report describing compliance by the participating dealer during that financial year with the applicable requirements of Parts 9, 10 and 11 in connection with its distribution of securities of all mutual funds in that financial year; and
- a report by the auditor of the participating dealer.

In the Study Group’s view, the auditor’s reports on mutual fund compliance, principal distributor compliance and participating dealer compliance should take the form set out in National Instrument 81-102 (Part 12).

Furthermore, the Recommendations contained in the following two CICA Handbook Sections are relevant to the reports in Exhibits 8.2 to 8.7: “Special Reports – Introduction” (Section 5800), and “Special Reports – Audit Reports on Compliance with Agreements, Statutes and Regulations” (Section 5815).

**PROSPECTUSES AND ANNUAL REPORTS**

**Investment Fund Prospectuses**

*CICA Handbook – Assurance* Section 7110, “Auditor Involvement with Offering Documents of Public and Private Entities,” deals with matters of general principle and practice relating to auditor involvement with offering documents, not with detailed requirements of securities legislation. To fulfill their professional responsibilities, however, auditors of investment funds need to be familiar with the applicable requirements of securities legislation.

A prospectus or offering circular is prepared in connection with the sale or exchange of corporate securities. It provides information to help prospective investors decide whether or not to buy the securities. A long-form prospectus contains detailed financial and other information about an issuer. That issuer may also publish a short-form prospectus when it meets the applicable requirements of securities legislation. That will contain information concerning the securities being issued and incorporate by reference certain information previously made available to the public under continuous disclosure requirements.

Paragraph 7110.07 states that “financial statements and other information to be included in a prospectus are set out in securities legislation.” Paragraph 7110.02 sets out the minimum requirements for an auditor who consents to the inclusion in an offering document (either Canadian or foreign) of the report on financial statements that the auditor has audited or reviewed.

National Instrument 81-101 *Mutual Fund Prospectus Disclosure* and its companion policy and related forms set out the prospectus filing requirements for mutual funds. They also spell out the disclosure mutual funds need to provide to satisfy the prospectus requirements of securities legislation. NI 81-101 states that a mutual fund’s most recently filed audited financial statements, any interim statements filed after those audited statements and the associated interim or annual Management Report of Fund Performance (MRFP) have to be made available to any person or company requesting them. These financial statements and MRFPs are incorporated by reference into a mutual fund’s prospectus, which is known as a simplified prospectus.

*CICA Handbook – Assurance* Section 7115, “Auditor Involvement With Offering Documents of Public and Private Entities – Current Legislative and Regulatory
Requirements,” provides additional guidance on current legislative and regulatory requirements, describing:

1. The requirement to agree, in a letter to the relevant authorities, that the auditor’s report on financial statements will be included in the prospectus. The requirement is in addition to the auditor’s consent included in a prospectus as referred to in CICA Handbook – Assurance (Section 7110).

2. The requirement to advise the authorities, in the consent letter, that the auditor has read the entire prospectus and knows of no misrepresentations in the prospectus information derived from the financial statements.

3. The requirement to provide comfort on pro forma financial statements or summarized financial information.

4. The requirement, when permitted, to provide a comfort letter (an “advice letter”) when audited financial statements with an unsigned opinion are included in a preliminary prospectus.

Investment fund products have evolved over the years and many different types of structured products are now available to the general public. The auditor’s involvement with these products is described in CICA Handbook Section 7115 and in CICA Handbook – Assurance Section 7200, “Auditor Assistance to Underwriters and Others.” This latter section provides guidance to auditors asked to issue a comfort letter or participate in a due diligence meeting related to a securities offering.

An issuer ordinarily agrees to retain its auditor to assist its underwriter or agent in conducting any investigation into the issuer’s affairs. The underwriter is engaged to carry out the public offering and assumes an obligation to ensure that prospective investors receive adequate disclosure on the proposed issue. When an offering is made by a prospectus, securities legislation requires the underwriter to certify that, to the best of its knowledge, information and belief, the prospectus constitutes “full, true and plain disclosure” of all material facts relating to the securities being offered. To assist with this due diligence process, auditors are often engaged to issue a comfort letter and/or participate in a due diligence meeting. Among other considerations, auditors can properly make a statement only if there are suitable criteria against which to evaluate the subject matter. Furthermore, auditors should not indicate in any manner that they can make any representation on the sufficiency of the procedures for the underwriter’s purposes.

Investment Fund Annual Reports, Interim Reports and Other Public Documents

CICA Handbook – Assurance Section 7500 addresses “Auditor Association with Annual Reports, Interim Reports and Other Public Documents.” These “designated public documents” can be categorized into two main groups.

The first group includes documents containing either full or summarized financial statements that the auditor has audited or reviewed, such as:

(a) an annual report, as the other information may be relevant to an audit performed by an auditor and the continuing propriety of the audit report on the financial statements in the annual report;

(b) an interim report when the auditor has performed an audit or interim review of financial statements in the interim report; and

(c) another public document only when the auditor has been engaged to read it or perform other services with respect to that document. These types of “other” documents can include a preliminary prospectus or prospectus filed with securities
regulatory authorities, an offering memorandum relating to a private placement or other exempt offering of securities, a management information circular, a continuous disclosure document or any other publicly available document.

The second group comprises the Annual Information Form (AIF) and the Management Report on Fund Performance prepared for filing with securities regulatory authorities. Although these documents do not normally contain financial statements, the information in them may be derived from the financial statements. In addition, the documents may be later incorporated by reference into a securities offering document such as a prospectus.

When the financial statements and the associated audit report are to be incorporated or included in a public document, the auditor would arrange to obtain the document prior to its release:
\begin{itemize}
  \item to determine whether the financial statements and the audit report have been accurately reproduced (see paragraphs 7500.15-.20); and
  \item to read the other information in the designated public document and consider whether any of that information raises questions about, or appears to be inconsistent with, the financial statements. No opinion, either positive or negative, should be expressed on such other information unless the information has been audited or reviewed (see paragraphs 7500.21-.30)
\end{itemize}

There should also be a clear understanding of the timing and extent of the auditor’s involvement with other public documents, including the annual report, AIF, interim reports and MRFP (see paragraph 7500.13).

When reading the annual report or MRFP, an auditor may become aware of other information that, although not inconsistent with the financial statements, appears to be a material misstatement of fact. In these circumstances, the auditor would discuss such concerns with management and the audit committee. If the auditor still believes that there has been a material misstatement of fact, the auditor would formally notify the governing body and consider what further action, if any, may be appropriate. Guidance is contained in CICA Handbook – Assurance Section 5405, “Date of the Auditor’s Report,” Subsequent discovery of a misstatement in the financial statements, or Section 7050, “Auditor Review of Interim Financial Statements,” Resolution of matters arising from an interim review.

Regulatory authorities often require investment funds to file their designated public document in more than one language. In these situations, auditors should be satisfied that each version of the document that they are associated with includes the same information and has been properly translated so that it is not inconsistent with the financial statements or the audit report (see paragraph 7500.39).

In the Study Group’s view, the Recommendations in CICA Handbook – Assurance Sections 7110 and 7500 also apply to investment fund financial reporting. The Study Group believes that investment fund managers and their auditors should recognize the need to prepare designated public documents so that they highlight significant information to investors and other interested parties while also fulfilling the requirements of regulatory authorities.

OTHER ASSURANCE SERVICES

The terms of reference for this project called for the Study Group to consider the potential role of practitioners in the provision of assurance services to the investment funds industry (for example, with regard to regulatory compliance matters, control systems, governance processes, assistance to audit committees, code
of ethics, conflicts of interest and safeguards against abusive trading).

Auditors, in their capacity as independent providers of expert professional assurance and advisory services, are well positioned to assist investment funds in achieving their objectives. Working with a fund’s governing body and senior management, the accounting profession can provide, and currently is providing, assistance in identifying risks and control measures to facilitate the achievement of the fund’s mission. In this regard, many believe that providing assurance on information required for strategic decision making may be as important as the assurance provided by the audit of financial statements.

NI 81-106, Section 8.2, provides an exemption for labour-sponsored and venture capital funds from the requirement to disclose individual current values for venture investments in their Statement of Investment Portfolio if, among other things, they have obtained an independent valuation of the value of the venture investments or of the net asset value of the fund and have filed the independent valuation concurrently with the annual financial statements.

Labour-sponsored investment funds and venture capital funds may choose to comply with this requirement of NI 81-106 by asking their auditor for a valuation review of the net assets of each class of shares as at each date of the fund’s statement of net assets. The auditor expresses an opinion in the valuation review (which is normally prepared with the assistance of qualified chartered business valuators) that the fair value determined by the valuation committee of the investment fund is reasonable in all material respects within the context of the fund’s financial statements taken as a whole.

When a labour-sponsored investment fund or a venture capital investment fund chooses to comply with this NI 81-106 requirement by receiving a valuation review from its auditor, the Study Group considers that such a review derives from the auditor’s opinion on the investment fund’s financial statements. In addition to the relevant recommendations referred to above under “Audit of Financial Statements,” the Study Group also considers that the following CICA Handbook – Assurance material applies: Section 5800, “Special Reports – Introduction,” and Section 5805, “Special Reports – Audit Reports on Financial Information Other Than Financial Statements.”
Appendix A

INVESTMENT FUND RISK/CONTROL FRAMEWORK

In light of an investment fund’s accountability to investors, Chapter 1 of this Research Report proposes a risk/control framework for investment funds. Exhibit A1 presents that framework in its entirety. The exhibit shows the four areas covered by the framework: nature of business (discussed in Chapter 2), governance (discussed in Chapter 3), operations (discussed in Chapters 4, 5 and 6), and compliance (discussed in Chapters 7 and 8).

The major components and key risk elements of an investment fund’s “nature of business” are:

- strategic management, which encompasses performance, client service, product development, sales and marketing, distribution channels and the integrity of management;
- operating environment, which encompasses governance, operating structure, business continuity and information technology;
- regulatory environment, which encompasses legal structure and compliance requirements;
- marketplace environment, which encompasses competition, complexity of fund structures, distribution strategies and financial risks.

The major components and key risk elements of an investment fund’s “governance” are:

- leadership, which encompasses independence and effectiveness of the governing body;
- stewardship, which encompasses the mandate of the fund manager and the independent review committee as well as the ethics program;
- responsibility, which encompasses the oversight of conflicts of interest and risk management;
- accountability, which encompasses the oversight of the financial reporting process and communications.

The major components and key risk elements of an investment fund’s “operations” are:

- agency relationships, which encompass investment adviser, transfer agent and custodian;
- valuation of investments, which encompasses basic methods of valuation, securities valued using publicly-traded available quotations, securities valued using other than publicly-traded available quotations, and special circumstances affecting the valuation of investments;
- fund accounting and reporting, which encompasses calculating the NAV per security, identifying and correcting pricing errors, financial reporting and performance reporting including the management report on fund performance (MRFP);
- information systems, which encompass reliance on information technology, information systems related risks, and risk management.

The major components and key risk elements of an investment fund’s “compliance” are:

- legal and regulatory, which encompass the investment objectives and restrictions, asset valuation and daily pricing, safeguarding of assets, reporting and continuous disclosure, sales practices, and investment fund manager registration;
- industry practices, which encompass GAAP, and the standards and guidelines established by IFIC, AIMA and the CFAI;
- taxation, which encompasses unit trusts and mutual fund trusts, mutual fund corporations, and partnerships;
- assurance reports, which encompass the audit of financial statements, compliance with National Instrument 81-102, prospectuses and annual reports, and other assurance services.
## Exhibit A1

**INVESTMENT FUND RISK / CONTROL FRAMEWORK**

<table>
<thead>
<tr>
<th>Nature of Business</th>
<th>Governance</th>
<th>Operations</th>
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<td>Operating Environment</td>
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Normally, an engagement letter is provided by the auditor to the investment fund in connection with the audit of the financial statements of an investment fund. To reduce the risk that either the auditor or the investment fund may misinterpret the needs or expectations of the other party, it is in the interest of both parties, preferably before the engagement commences, to establish a mutual understanding in a written agreement. The engagement letter would normally address the following matters:

• audit services and related reports;
• auditor’s responsibilities;
• management’s responsibilities; and
• fees for audit services.

The engagement letter would also set out specific terms and conditions, for example:

• timely performance;
• rights to terminate services;
• electronic mail (e-mail) communications;
• personal information protection;
• fees and payment;
• indemnification for misrepresentation by management or the board of directors;
• working papers;
• reproduction of financial statements;
• confidential information;
• assisting firms;
• assignment of claims;
• consent to production;
• governing law;
• extent of liability;
• severability.
A management representation letter is normally provided to the auditor by the investment fund in connection with the audit of the financial statements of an investment fund. The written representations of management provide evidential matter that the auditor relies on in forming an audit opinion on the financial statements. Certain representations in this letter will be limited to matters that are material. Items are considered material, regardless of size, if they involve an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would be changed or influenced by the omission or misstatement.

Matters that would be considered for inclusion in the management representation letter include:

- A statement of management’s responsibility for preparation and fair presentation of the financial statements in conformity with generally accepted accounting principles.
- A statement confirming an understanding of the auditor’s responsibilities.
- A statement that all financial and accounting records and related data have been made available, for example:
  - minutes of all meetings of investors, directors and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared;
  - information relating to all statutes, laws, or regulations that have a direct effect on the financial statements;
  - all reports from other accountants who have been engaged to make a review of financial information of significance to the Fund;
  - all information relating to contracts with and results of work done by specialists.
- A statement that there have been no communications from regulatory agencies, such as the OSC or CRA, concerning noncompliance with or deficiencies in financial reporting practices.
- A statement that there are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
- A statement that there has been no fraud (either suspected or known) involving management or employees who have significant roles in internal control, and no fraud involving others that could have a material effect on the financial statements.
- A statement that the following have been properly recorded or disclosed in the financial statements:
  - related party transactions and other transactions with affiliates, including fees, commissions, purchases and sales;
  - guarantees, whether written or oral, under which the Fund is contingently liable;
  - significant estimates and material concentrations known to management that are required to be disclosed in accordance with generally accepted accounting principles;
  - arrangements with financial institutions involving compensating balances, or other arrangements involving restrictions on cash balances and lines of credit or similar arrangements;
— capital stock repurchase options or agreements, or capital stock reserved for options, warrants, or other requirements (possibly applicable to closed-end funds);
— all financial instruments (such as swaps, forwards, and futures) at fair value, as required under generally accepted accounting principles.

• A statement that there are no violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
• A statement that management is not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with generally accepted accounting principles.
• A statement that the Fund has satisfactory title to all owned assets, and there are no liens or encumbrances on such assets, nor has any asset been pledged as collateral.
• A statement that the Fund has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.
• A statement that, to the best of management’s knowledge and belief:
  — Portfolio investments are stated at fair value as determined in accordance with GAAP for financial reporting purposes and are also consistent with the valuation methods set forth in the current prospectus and constating documents for transactional purposes. All Fund investments during the period were made in accordance with the investment policies stated in the current prospectus.
  — The Fund has complied with the provisions of pertinent legislation (for example, Ontario Securities Act) and the rules and regulations thereunder, and with the provisions of its prospectus under which the Fund operates. Fund shares/units were sold and redeemed throughout the year, and the daily net asset value was properly computed throughout the year, in accordance with pertinent regulatory requirements.
  — The Fund did not make any commitments during the year as underwriter, nor did it engage in any transactions made on margin, in joint trading or in a joint investment account, or in selling short.
  — The Fund has complied with the requirements of the Income Tax Act and the CRA, through the date of this letter, and intends to continue to so comply.
  — The Fund, except to the extent indicated in its financial statements, does not own any securities of persons who are directly affiliated.
  — The Fund has complied with the provisions of its code of ethics.
  — No events or transactions have occurred subsequent to the date of the statement of net assets of the Fund and through the date of this letter that would require adjustment to or disclosure in the financial statements.
Appendix D

VALUATION OF SPECIFIC TYPES OF SECURITIES

This Appendix provides a general description of various types of securities and transactions, and includes pertinent notes on accounting, disclosure and valuation considerations. It supplements the discussion in chapter 4 with regard to Valuation of Investments.
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<td>1. ADRs, GDRs, subscription receipts, participatory notes, etc.</td>
<td>A certificate, denominated in US dollars, issued by an American bank to provide evidence of ownership of original foreign shares. The certificate is transferable and can be traded. The original foreign stock certificate is deposited with foreign branch or correspondent bank of the issuing American bank. These are commonly used in global equity offerings to US and non-US investors. It facilitates cross-border trading and settlement, minimizes transaction costs and broadens a non-US company's potential investor base. A depository receipt is a negotiable certificate that usually represents a company's publicly-traded equity or debt. These are created when a broker purchase the company's shares on the home stock market and delivers them to the depository's local custodian banks, which then instructs the depository bank to issue depository receipts. Depository receipts may trade freely, just like any other security, either on an exchange or in the over-the-counter market.</td>
<td>These are priced at bid prices from independent service provider for financial reporting purposes.</td>
<td>Typically ADRs and GDRs are fully tradable on an exchange and would be valued in the same manner as equities (the last traded price or official close price on the primary exchange on which it trades). Participatory notes are not listed and would be valued utilizing the price of the underlying security based upon the terms of the note (e.g., one note represents 10 shares of the underlying). If a GDR or ADR is deemed illiquid then it could be valued in the same manner as participatory notes. Subscription receipts are quite common for Canadian securities and are valued in the same manner as Special Warrants under NI 81-102.</td>
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<td>2. Futures and forwards</td>
<td>An agreement to buy or sell, at a specified future date and price, a specified quantity of commodity, currency or financial instrument. Futures contracts are traded on various exchanges and are, thus, distinguished from forward contracts, which are entered into privately by the parties. For futures contracts, the date is a specified delivery month, and the contract generally is settled by executing an offsetting futures contract before or during the delivery month. The quantity and quality provisions of futures contracts are standardized. This is not the case for forward contracts. Most forwards are settled in cash. Forward contracts are entered into directly between two counterparties for future delivery receipt at a specified price. As a result, they do not settle up on a daily basis via margin settlement as do futures contracts.</td>
<td>Future contracts are valued at bid prices for financial reporting purposes. The accounting records for future contracts reflect the margin deposit and the daily mark to market for variation margin. Futures contracts are marked to market daily; that is, they are valued at the close of business each day (valued at the settlement prices established by the exchanges), and a gain or loss is recorded for the difference between the value of the contracts that day and on the previous day. Because market quotations are often not readily available for forward contracts, their fair values should be estimated using valuation techniques. The terms for the securities covered by the contract should be compared with the terms of similar securities, if prices for those securities are readily available. A forward contract that offsets the economics of an existing contract may not qualify for netting unless the requirements of Section 3863.26 are met. For futures, a corresponding entry for daily variation margin is recorded in a receivable or payable account. Variation margin is normally settled in cash with the broker each morning for the amount of the previous afternoon’s mark to market. When a contract is closed, exchange fee and brokers’ commissions are calculated. A final variation margin payment, net of such fees, is recorded and a corresponding amount is recorded as a gain or loss. Exchanges limit intraday fluctuations in prices of futures contracts, referred to as daily limits. During a single trading day, trades may not be executed at prices exceeding the daily limit. Once the price of a futures contract has increased or decreased by an amount equal to the daily limit, positions cannot be taken or liquidated unless traders are willing to trade at or within the limit. The bid price for a particular futures contract may move by the amount of the daily limit for several consecutive days with little or no trading. The fair value of futures positions affected by a daily limit should be estimated by applying appropriate valuation techniques. NI 81-106 requires disclosure of the terms of the futures contract, including the number of contracts, the underlying interest, the price at which the contract was entered into, the delivery month and year and the current value (3.5(6)(b)).</td>
<td>Futures are valued using the last traded price on a recognized exchange in a manner similar to equities. Forward currency contracts are valued utilizing the trading quotation of spot plus or minus points depending on the length of the forward. Typically, a price is interpolated from between two trading points (i.e., if there are 75 days left, the price is derived from the 60 and 90 day forward quotes). Forward contracts are valued utilizing the terms of the specific contract. They vary widely, so there is no set way to value them. There are also typically no broker quotes.</td>
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<td>3. Money market instruments</td>
<td>Short-term investments such as treasury bills and other government obligations, commercial paper, bankers’ acceptances, and certificates of deposit with a term to maturity of 365 days or less.</td>
<td>The bid quotations obtained from investment dealers are used for valuing the instruments for financial reporting purposes. Industry practice is to use amortized cost on the basis that it would not be materially different than fair value. However, the accounting policy note should state that fair value or bid price has been used. Typically valued at amortized cost, approximating market value. This assumption needs to be tested regularly to ensure it continues to be valid. Testing includes obtaining broker bids and independent valuations.</td>
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<td>4. Mortgage-backed securities (MBS)</td>
<td>An asset-backed security issued on a pool of underlying mortgages. A pass-through security created by pooling mortgages and selling interests or participations in the MBS. Usually, the mortgage originator will continue to service the underlying mortgage. Principal and interest payments received from mortgagors will then be passed on to the MBS holders.</td>
<td>In valuing MBSs, investment funds should distinguish between seasoned and unseasoned securities. Mortgages are not homogeneous and, as a result, different pools have different prepayment experience. MBSs are considered seasoned once they have been outstanding four to five years. Generally, MBS price quotes can be readily obtained from dealers or pricing services. If independent price quotations are not available, the characteristics of the MBS should be factored into the valuation technique. MBS instruments may be purchased at a premium or discount. General industry practice is to recognize the premium or discount at the disposition date of all or part of the security rather than amortizing the amount. The Study Group concurs with this practice.</td>
<td>Bonds are valued at either bid or mid price. MBS securities can be quoted on a factored or non-factored basis depending on whether or not there is a decision to adjust the face value of the bond for the principal factor paydown.</td>
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<td>5. Purchase warrants, special warrants</td>
<td>Certificates issued by a corporation that give the holder the right to purchase the underlying assets at a set price for a set period of time. The certificates are often issued in conjunction with a new issue of bonds, preferred shares or common shares.</td>
<td>Traded warrants are priced at bid from an independent service provider for financial reporting purposes. Non-actively traded warrants use valuation techniques based upon observable market rates and/or may include models. Disclosure may include exercise price and date of expiry of the warrants.</td>
<td>Purchase warrants should be valued based on a valuation model (for example, Black Scholes Option Pricing Model or Binomial Model).</td>
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<td>6. Put and call options (written and purchased)</td>
<td>A contract that gives the owner the opportunity to buy (in the case of a call option) or sell (in the case of a put option) the underlying security from or to, respectively, the writer of the option at a fixed price (called the exercise price) on or before the option's expiry date. In return for this right, the purchaser pays a nonrefundable fee (the premium) to the writer of the option. The amount of the premium is based on factors such as the duration of the option, the difference between the exercise price and the current market price of the underlying security, the volatility in the price, current interest rates and other characteristics of the underlying security. Option trading consists of both listed and over-the-counter markets in options. The exercise price and number of units/shares of equity options are generally adjusted on the ex-date for rights and stock dividends or splits in the underlying shares.</td>
<td>Purchased options: The premium paid by an investment fund for the purchase of a call or put option should be included in the statement of net assets as an investment and subsequently marked to market to reflect the current market value of the option. When an option that an investment fund has purchased expires on the stipulated expiration date, the investment fund will realize a loss in the amount of the cost of the option. When an investment fund enters into a closing transaction, it will realize a gain or loss, depending on whether the proceeds from the closing transaction are greater than or less than the cost of the option. When an investment fund exercises a put option, it will realize a gain or loss from the sale of the underlying security and the proceeds from such sale should be decreased by the premium originally paid. When the investment fund exercises a call option, the cost of the security which it purchases upon exercise should be increased by the premium originally paid.</td>
<td>Options which are listed are valued using the last traded price on the recognized primary exchange. If the options are traded OTC, value can be based on the price of a listed option if they have the exact same terms. If the OTC option does not have a listed counterpart, it should be valued based on a valuation model (for example, the Black-Scholes method).</td>
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<td>Written options: Premiums from writing options should be included in the statement of net assets as a liability and subsequently marked to market to reflect the current market value of the option, with the offsetting entry recorded as unrealized gain or loss. Premiums received from writing options that expire unexercised are treated on expiration date as realized gains. An option writer’s obligation may also be discharged before the exercise of the option by closing out its position. The difference between the premium received and the amount paid on executing a closing transaction is treated as a realized gain or, if the cost of the closing transaction exceeds the premium received, as a realized loss. When an option holder exercises the right to call or put the security, the writer’s obligation is also discharged. In the case of a call option, the writer delivers the underlying security and receives the exercise price. For a covered position, the difference between the proceeds of the sale plus the amount of the premium and the cost of the security should be accounted for as a realized gain or loss. For an uncovered position, a realized loss from the simultaneous purchase, at market, and sale, at the option strike price, of the security should be reduced by the premium. For a put option, the cost recorded by the investment fund for the security delivered as part of the option contract should be the exercise price of the option plus commissions less the premium received.</td>
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<td>Disclosure: NI 81-106 requires disclosure of the terms of the options including the quantity of the underlying interest, the number of options, the strike price, the expiration month and year, the cost and the current value (35.6(a)).</td>
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<td>7. Real return bonds (RRB)</td>
<td>Government (federal/provincial) bonds that pay a rate of return that is adjusted for inflation. Unlike regular (nominal) bonds, this feature assures that your purchasing power is maintained regardless of future rate of inflation. RRBs pay interest semi-annually based on inflation-adjusted principal and at maturity they repay the principal in inflation-adjusted dollars. RRBs have many of the return characteristics of long-term bonds with interest rate sensitivity of short-term bonds.</td>
<td>RRBs are valued at bid prices for financial reporting from independent service providers.</td>
<td>Bonds are valued at either bid or mid price. Real Return Bonds can be quoted either on an adjusted or non-adjusted basis which reflects the intrinsic value of the CPA adjustment.</td>
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<td>8. Repurchase agreements (and reverse repurchase agreements)</td>
<td>A repurchase agreement (repo) is, in its simplest form, the sale of a security at a specified price with an agreement to purchase the same or substantially the same security from the same counterparty at a fixed or determinable price at a future date. A repurchase agreement allows the investment company to transfer possession of a security to a buyer, usually a broker, for cash. The investment company agrees to repay cash plus interest in exchange for the return of the same securities. Because a repo between the two specific parties involved is not transferable, a repo has no ready market. A reverse repurchase agreement (reverse repo or resale) is, in its simplest form, the purchase of a security at a specified price with an agreement to sell the same or substantially the same security to the same counterparty at a fixed or determinable price at a future date.</td>
<td>A repurchase agreement allows the investment fund to transfer possession of (sell) a security to a buyer, usually a broker, for cash. The investment fund does not record a sale of the security, and it agrees to later repay cash plus interest in exchange for the return (repurchase) of the same securities. The transaction is thus similar in effect to a borrowing by the investment fund, collateralized by the security. The contract may be a daily contract that is continually renewed. The proceeds of the transaction should be recorded as if they were of a borrowing, and the security should continue to be recorded as if it were in the portfolio, though subject to lien, and should be valued in a manner suited to it. A reverse repo is similar to a loan by the investment fund to the seller, with the securities serving as collateral. The investment fund does not record the purchase of the securities received but does record the reverse repo as if it were a loan. Income or expenses associated with these transactions need to be disclosed under the statement of investment operations.</td>
<td>Repurchase agreements – continue to value security in the same manner as prior to agreement. Reverse repurchase agreements – value as a short-term investment, (i.e. at cost plus accrued interest).</td>
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<td>9. Restricted securities for regulation or other purposes</td>
<td>A portfolio security that may be sold privately. It is probably exempted from registration but some aspect of its nature is restricted in some manner.</td>
<td>Disclose why the security is restricted and disclose to allow reader to understand impact. There may be a discount or premium consideration.</td>
<td>Consider whether a liquidity discount (&quot;haircut&quot;) is appropriate.</td>
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<td>10. Securities lending</td>
<td>The practice of lending portfolio securities, usually to a broker to cover a short sale. The loan is usually collateralized by cash or government securities. Investment funds used this strategy to enhance the returns.</td>
<td>Disclosure includes market value of securities loaned and collateral held. Income from this lending activity should be reported in the statement of operations when earned.</td>
<td>Continue to value security in the same manner as prior to agreement.</td>
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<td>11. Short securities positions</td>
<td>A short sale is a sale of securities not owned at the time of sale but where the buyer anticipates the price to fall so that the securities can be purchased at a profit. A fund selling short borrows equivalent securities to deliver to the buyer and eventually buys the securities to return to the lender.</td>
<td>Short securities positions should be valued at the current ask price, except where a fund has offsetting assets and liabilities with offsetting market risks (in which case mid-market is appropriate). Amounts deposited with brokers for short sales of securities should be separately disclosed. Proceeds from securities sold short should be reported as liabilities in the statement of net assets and marked to market. The difference between the net proceeds of the short sales and the valuations should be reported as unrealized appreciation or depreciation of the investments in the statement of operations. Gains and losses should be classified as realized when a short position is closed out.</td>
<td>Value in the same manner as equities, with the qualification that if not priced at last trade, use ask or mid of bid/ask rather than bid.</td>
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<td>12. Stapled units</td>
<td>A unique form of security that combines the attributes of common shares, preferred shares and debt in a single security. These are “stapled” together as a single unit that trades in the stock market.</td>
<td>These are priced at bid prices from independent service provider for financial reporting purposes.</td>
<td>These securities typically trade in the market (see description) so they would be valued at the last traded price (or official close) on the recognized primary exchange.</td>
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<td>13. Structured notes or indexed securities</td>
<td>Structured notes are hybrid investments that have components of straight debt instruments and derivatives combined into one structure. Rather than paying a straight fixed or floating coupon, these instruments’ interest payments are tied to a myriad of possible indices, rates or other underlying assets. The derivative component can affect the redemption value and stated maturity of the note. Structured notes vary by their underlying assets – they may be linked to a group of mutual funds, hedge funds, equity index or group of indices, or basket of selected stocks – and usually pay interest based on an increase (or decrease) in the underlying asset. An example would be a Principal Protected Note (PPN).</td>
<td>These are valued at bid prices by the investment dealers. Minimum disclosure includes principal value, credit rating of the issuer, maturity date, underlying assets used and interest or rate of return information.</td>
<td>Multiple broker quotes and/or valuation model based on the features of the note.</td>
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<td>14. Swaps</td>
<td>A series of forward contracts which obligate two parties to swap or exchange a series of cash flows on specified payment dates. The cash flows are either fixed or calculated by specified reference rates or prices. Interim payments are netted, with the difference being paid by one party to the other. A swap is a particular type of OTC forward contract. The most common type is one that is based on interest rates. In a basic plain vanilla interest rate swap, two parties agree to swap cash flows based on two different rates (one fixed, the other floating) on a certain principal amount, and on a certain date. Other types of swaps include cross-currency interest rate swaps, equity swaps, index swaps, total return swaps and commodity swaps.</td>
<td>Swaps are not traded on exchanges; therefore, market quotations are not available for swaps. Fair values should be used. Disclosures may include swap arrangement details such as underlying asset, maturity date, counterparty and their rating, notional amount, market value and payable or receivable amounts.</td>
<td>Swaps should be valued using a model that incorporates the terms of the swap agreement and relevant market data to calculate the net present value of the expected future cash flows. Typically, broker quotes are not available.</td>
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<td>15. When-issued securities</td>
<td>A short form for “when, as and if issued.” The term indicates a conditional transaction in a security authorized for issuance but not yet actually issued. All such transactions are settled if and when the actual security is issued and the exchange determines that the transactions are to be settled. Some securities are traded on a when-issued basis. A securities underwriter solicits expressions of interest in a proposed issue and sends a when-issued price confirmation against which securities are delivered later when the terms of the issue are known. The securities usually begin trading on a when-issued basis on the issuance of the confirmation as if they had been issued a few days before the closing date. In Canada, when-issued securities may include treasury bills, provincial bonds, corporate bonds and government of Canada bonds. Securities, such as government of Canada bonds, can be bought and sold in advance of the issue date, and trading may begin at the time of the announcement.</td>
<td>Securities offerings are rarely aborted after when-issued trading begins. A when-issued security and the obligation to pay for the security should be recorded when the commitment becomes fixed, which is the date on which the priced transaction confirmation is issued. When-issued securities for which the fund has not taken delivery are required to be identified in a registered investment company’s financial statements. Securities may also be bought on a delayed delivery contract under which the underwriter agrees to deliver securities to buyers at later specified dates.</td>
<td>Typically when-issued securities are tradable in the applicable market for the underlying security (listed on an exchange for a when-issued equity and OTC for a when-issued bond). In that instance, the normal pricing convention for the type of security would apply. If the when-issued security is not readily tradable then the security would be valued at cost (as a proxy for fair value) until such time as it becomes tradable (or other evidence of fair value becomes available).</td>
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<td>16. Zero coupon bond</td>
<td>A discount bond that pays a single lump sum payment at maturity; no periodic coupon payments; predominantly OTC instruments traded by dealers. It is generally issued at a discount from its face value. The holder derives the return from the gradual appreciation in the value of security, which redeems at face value at a specified maturity.</td>
<td>These instruments are traded OTC and their bid prices for financial reporting are available from dealers. The Study Group recommends the “notional interest income method” (required under Canadian income tax regulations). Under this method, the zero coupon bond is “marked to market” and an accrual is made for the interest income. The income stream is conceptually in two components, an accretion of the discount using a constant yield to maturity, and fluctuations in value due to changing interest rates or credit worthiness of the issuer. The interest accrual is based on the yield to maturity in effect at the time of purchase. The offset is to the cost of the zero coupon bond.</td>
<td>Bonds are valued at either bid or mid price.</td>
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Appendix E

MONITORING THE CONTROL ENVIRONMENT

An investment fund’s control environment, including the control environment in place at each of its servicing agents, reflects management’s philosophy, attitude and demonstrated commitment to establishing a positive atmosphere for the implementation and execution of well-controlled business operations. It strongly influences the effectiveness of the fund’s control measures and, accordingly, significantly affects the assessment of business risks. Chapter 2 of this Research Report addresses the four major risk components related to the nature of business (strategic management, operating environment, regulatory environment and marketplace environment) and the pertinent risk elements that merit consideration.

Analysis of an investment fund’s control environment calls for ongoing monitoring of:

- the approach and processes of the fund’s governing body and management;
- the fund manager’s organizational structure and that of its servicing agents;
- the processes at the fund manager to mitigate various risks faced by investment funds; and
- errors, omissions and control failures.

Properly designed and executed monitoring provides persuasive information to the right people regarding the control system’s effectiveness. It also identifies and communicates control deficiencies in a timely manner to those parties responsible for taking corrective action and to fund management and the governing body, as appropriate. In doing so, it facilitates the correction of control deficiencies before they affect the achievement of the fund’s objectives.

Investment funds should consider an optimal approach to monitoring as follows:

- Monitoring considers how the entire control system addresses meaningful risks, not how individual control activities operate in isolation, without regard to the level of risk and the effectiveness of other elements of the control system.
- Monitoring works best when management approaches it proactively, establishing a baseline understanding of control effectiveness and an information system that alerts it to changes in control processes or risks that affect the need to change or add controls.
- The governing body has important responsibilities in monitoring control, especially the controls that relate to ensuring a strong tone from the top and in mitigating the risk of management override.
- Internal audit, through added skills and objectivity, can play an important role in assisting management and the governing body in monitoring, especially as a fund grows in size and complexity.
- Funds should follow a systematic process in determining what and how to monitor. That process starts with identifying and prioritizing the risks that are being mitigated by effective control measures.
- Monitoring can be performed using ongoing monitoring activities or separate evaluations, but ongoing monitoring using persuasive information is often effective and efficient.
- Computerized applications have undergone substantial development and can be built into, or added onto, existing computer applications, providing continuous monitoring.
- Judgment is required in determining the optimal approach to monitoring and the effectiveness of monitoring.
The quality of leadership provided by a fund’s governing body and management significantly influences the control environment. Members of the fund’s governing body who are knowledgeable, experienced and have a proven track record should be able to identify and address potential problems well before they adversely affect the fund. Chapter 3 of this Research Report addresses the four major risk components of governance (leadership, stewardship, responsibility and accountability) and the pertinent risk elements that merit consideration.

Establishing clear delegation of authority and assignment of responsibility in a fund manager’s organizational structure and in that of its servicing agents facilitate the execution of management’s policies, development of relevant and reliable feedback and the selection, motivation and promotion of qualified people. The methods by which fund management plans, executes and controls the day-to-day operations provide a sound basis for assessing the strength of the control environment. Chapters 4, 5 and 6 of this Research Report address the four major risk components of operations (agency relationships, valuation of investments, fund accounting and reporting, and information systems) and the pertinent risk elements that merit consideration.

In an investment fund context, key controls that require ongoing monitoring relate to:

- investments (including investment operations);
- investment income, gains and losses;
- expenses and disbursements;
- financial accounting and reporting;
- tax compliance; and
- investor accounts (unitholder activity).

Controls measures over investments should provide reasonable assurance that:

- investment transactions (for example, purchases, sales, cancels and corrects) that are input for trade processing are authorized, accurate, complete and executed on a timely basis;
- investment transactions and related cash transactions are confirmed and/or affirmed with the appropriate parties and recorded in the accounting records in the proper period;
- portfolio transactions are processed and recorded at the correct foreign exchange rates;
- portfolios are valued using prices and foreign exchange rates obtained from sources authorized by the investment adviser;
- physically held securities are protected from loss, misappropriation and unauthorized use;
- the fund’s records accurately and completely reflect securities held by third parties (for example, depositories or sub-custodians).

Control measures over investment income, gains and losses should provide reasonable assurance that:

- dividend and interest income and related cash receipts are recorded completely, accurately and in a timely manner;
- corporate actions are identified and processed accurately and in a timely manner;
- lender and borrower participation in lending programs is authorized;
- loans subject to securities lending arrangements are adequately collateralized, and collateral is recorded accurately and in a timely manner;
- investment cost balances are accurately recorded and maintained, and investment gains/losses are recorded completely, accurately and in the proper period.

Control measures over expenses and disbursements should provide reasonable assurance that:

- expense accruals and related disbursements are authorized and accurately recorded;
• expenses, income and gains/losses for multiple class funds are allocated among each class of shares completely and accurately;
• all fund activity is accurately and completely reflected in the fund’s general ledger.

Control measures over financial accounting and reporting should provide reasonable assurance that:
• the fund Net Asset Value (NAV) calculation is accurate and performed on a timely basis;
• financial statements included in the fund’s annual and semi-annual reports are prepared on the basis of appropriate and supporting data, and in accordance with Canadian generally accepted accounting principles and local regulatory requirements;
• adjustments proposed by the fund’s independent auditors are either reviewed and approved or waived by an appropriate fund official.

Control measures over tax compliance should provide reasonable assurance that:
• the fund maintains its tax status;
• the fund prepares and files all relevant tax returns with relevant tax authorities on a timely basis;
• the fund has, in a timely manner, made distributions to its investors to avoid taxes payable;
• the fund has or intends to distribute all of its income and capital gains;
• required tax basis information is properly presented within the fund’s financial statements.

Control measures regarding investor accounts should provide reasonable assurance that:
• accounts are opened and maintained in an authorized, accurate, complete and timely manner;
• purchases, redemptions and reinvestments input into the recordkeeping system are authorized, accurate and complete, for the proper period and valued at the proper dollar and unit/share amounts;
• dividends and distribution amounts are authorized, calculated accurately and completely, and properly recorded in the investor accounts;
• money movement is properly authorized, accurately and completely processed, and communicated to the fund accounting agent in a timely manner.

It is mandatory for investment funds to comply with all relevant legal and regulatory requirements. The following matters merit particular attention:
• investment objectives and restrictions;
• asset valuation and daily pricing;
• safeguarding of assets;
• reporting and continuous disclosure;
• sales practices; and
• point-of-sale disclosure.

Additional requirements or constraints may be imposed by a fund’s constating and continuous disclosure documents. When monitoring the control environment, an investment fund must consider compliance risks associated with legal and regulatory requirements. A principal objective is to ensure that the compliance function is well defined, responsibility is delegated to an appropriate individual or group, and adequate resources are provided.

Failure to comply with the legal and regulatory requirements can have serious consequences. The potential impact on a fund violating legal and regulatory requirements will depend on the nature of the violation, the period over which the violation occurred and the resulting loss, if any. In some cases, a violation may result in public embarrassment or in litigation between the investors and the investment adviser/fund manager. Violations of regulatory restrictions can trigger sanctions such as a cease trading order, which would prevent the fund from being bought or sold.
For these reasons, management should establish policies and procedures to ensure that a fund complies with all legal and regulatory requirements throughout the year, including:

- training designated individuals to understand the legal and regulatory requirements so that they can adhere to them;
- training designated individuals to independently monitor compliance of operations staff;
- implementing systems and procedures to identify, isolate and inform management of violations on a timely basis; and
- developing specific action plans to deal with violations promptly and effectively.

Chapters 7 and 8 of this Research Report examine investment fund compliance associated with legal and regulatory requirements.
Appendix F

CONTROL MEASURES FOR INVESTMENT FUND INFORMATION SYSTEMS

Supplementing Chapter 6 of the Research Report, this appendix identifies additional possible control measures for investment fund information systems that relate to key services regarding:

• transfer agency;
• trust accounting;
• investment management and trading;
• asset custody; and
• fund accounting.

TRANSFER AGENCY

The primary control objectives of the transfer agency function and related system/automated control activities include:

A. Controls provide reasonable assurance that investor account maintenance transactions are properly authorized and are recorded accurately and on a timely basis.

• User profiles restrict the ability to change standing data to appropriately authorized individuals.
• Edit and validation controls check the accuracy of updates to certain account holder information (e.g., banking information).
• The system produces automated exception reports when changes to standing data are made (e.g., banking information, investor address changes, suppression of investor confirmations, etc).

B. Controls provide reasonable assurance that transactions are authorized, processed accurately and on a timely basis and valued at proper dollar unit/share amounts.

• Transaction documents received are date and time stamped and forwarded electronically to the correct work-processing queue (transaction processing, quality control, exception/reject queues).
• Time-stamps are used to ensure that transactions are processed in the proper period and to substantiate the price.
• Access to processing functions and related data records for investors is restricted by user ID and password codes, terminal access controls and physical access controls.
• Edit and validation checks ensure that all authorized purchases and redemptions are entered for processing accurately, completely and once only.
• System edits prevent purchases of closed funds.
• Batch processing controls, session controls, programmed balancing controls, data transmission controls, restart and recovery controls and programmed cut-off controls ensure that purchases and redemptions are completely and accurately processed and recorded in the proper accounting period based on the transaction date.
• The system applies the correct price to transactions based on the date and class of share.
• The system ensures the value of inter-fund transfer balances.
• The system correctly records purchases and redemptions transactions in individual investor accounts.
• The system completely and accurately accumulates purchases and redemptions in the underlying financial records.
• Suspense accounts, error-recycle files and transaction reject reports notify users of rejected purchases and redemptions transactions, and keep track of them until the error has been corrected and the transaction reprocessed.
• Transaction validation calls made to investors are automatically recorded and captured by the system (e.g., voice objects are attached to the relevant transaction, which can be played back in the event of a dispute).
• Suspense and clearing accounts are used and items in suspense are aged to facilitate timely follow up and clearing.
• Outstanding purchases and redemptions exceeding a specified age are automatically cancelled.
• Controls to ensure or track compliance with regulatory and/or fund specific requirements are designed into the system.

C. Controls provide reasonable assurance that fee and commission rates are set up in the system in accordance with underlying agreements and that fee/commission calculations and payments are authorized and accurate.
   • User profiles restrict the ability to set-up or modify fee/commission rates in the system.
   • The system automatically calculates fees and commissions.

D. Controls provide reasonable assurance that dividend and distribution rates are authorized, and that dividend and distribution amounts are calculated and recorded accurately and on a timely basis.
   • Edit and validation controls ensure that dividend/distribution data entered for processing are accurate and complete.
   • Distributions to investors are completely and accurately calculated based on the distribution rate, units held as at the distribution date and regulatory requirements.
   • Distributions are reinvested or paid to investors in accordance with their instructions.
   • Reinvested dividends and distributions are correctly recorded in the individual accounts of investors.
   • Dividend/distribution transactions are completely and accurately accumulated and posted to the underlying financial records.
   • The expected total distribution for the fund, based on the total number of units in issue at the distribution date, is balanced to the total distributions.

E. Controls provide reasonable assurance that tax withholdings are properly calculated, recorded and remitted.
   • The system completely and accurately calculates and deducts with-holding tax from distributions.
   • With-holding tax deducted from payments is completely and accurately accumulated and posted to the underlying financial records for distribution to each tax jurisdiction.

TRUST ACCOUNTING
The primary control objectives of the trust accounting function and related system/automated control activities are:
A. Controls provide reasonable assurance that cash balances are reconciled and exceptions are promptly identified and appropriately resolved.
   • The system includes automated, exception-based reconciliation between transfer agency system and bank (identifies unmatched items), highlighting reconciling items for manual follow up.
B. **Controls provide reasonable assurance that cash receipts and disbursements are authorized, processed, and recorded completely and accurately.**
   - System-generated cheques sequentially numbered and exception reports of cheque sequence breaks are reported for investigation.
   - There is a manual cheque and cheque changes report.
   - The system generates deposit slip summary/batch deposit summary reports for reconciliation to bank statements.
   - Automated summary reports of “Purchases to Fund,” “Redemptions from Fund” and “Cash Distribution” are produced to facilitate the calculation of interest allocations.
   - The system performs automated, exception-based reconciliations between cash disbursements to dealers and commission/trailer fee reports.
   - The system performs automated, exception-based reconciliations between cash disbursements and the cheque assignment report.

**INVESTMENT MANAGEMENT AND TRADING**

The primary control objectives of the investment management and trading function and the related system/automated control activities are as follows:

1. **Account Management**

   A. **Controls provide reasonable assurance that investment guidelines and restrictions are established and fund portfolios are monitored for adherence.**
   - Access to respective trading systems and fund accounts is restricted to the designated investment advisers.
   - Risk management/designated staff summarize the guidelines detailed in the Statement of Investment Policies and Procedures or Investment Management Agreement (IMA) for each new fund and enter them into the compliance monitoring system. Access to make changes within the compliance monitoring system is restricted to members of risk management/institutional compliance staff.
   - The compliance monitoring system automatically logs all changes made to the investment guidelines (rules) and captures them in a report for review and approval.
   - Exception reports are generated daily from the compliance monitoring system, listing accounts that exceed asset mix or permitted security constraints.

B. **Controls provide reasonable assurance that derivative strategies are appropriately approved.**
   - Authorized staff establish rules for client-accepted derivative strategies in the compliance system.

2. **Portfolio Management**

   C. **Controls provide reasonable assurance that portfolio transactions are properly authorized, executed and allocated in a timely and accurate manner.**
   - Investment advisers are defined at the client level within the application and set-up by authorized members of the IT department to ensure that only designated managers are granted access to the respective systems to authorize and/or execute trades.
   - Violations to client guidelines/mandates are captured in a report, which is then reviewed by risk management staff as and when such violations occur.
   - For bulk trades, orders are pre-allocated prior to trade execution in accordance with internal policies, to ensure fair allocation (allocated
properly between funds/clients on pre-rata basis).
- New securities are set up within the appropriate accounting system based on information provided by the investment adviser.
- Trade desk telephone lines are recorded and can be referenced in the event of a dispute between the trade desk and the broker.

3. Transaction Processing

D. Controls provide reasonable assurance that portfolio transactions are recorded completely, accurately and on a timely basis.
- For electronic trades, files are automatically uploaded from the trading system to the portfolio accounting system throughout the day or initiated by the operations team on request. Electronic files are reviewed for rejected transmissions by the operation team and followed up. A custodian reconciliation is performed by the reporting team the following day to determine whether any failed trades require follow up.
- On a daily basis, the reporting team reconciles the portfolio accounting system detailed transactions to the trading system.
- The trading system automatically flags cancelled or corrected trades for audit purposes.

E. Controls provide reasonable assurance that transactions are undertaken only with approved counterparties.
- Trades can only be executed through a broker/dealer who is on the list of authorized broker/dealers (approved by the investment manager) maintained by the trading system.
- All additions and deletions to the approved list of authorized broker/dealers must be approved by management. Additions/deletions to the system broker list are performed by authorized IT staff who are independent of the staff members who execute the trades.
- A one-off broker/dealer is removed from the system once a transaction is completed. Approvals for one-off broker/dealers are ratified at the next management meeting.

ASSET CUSTODY

The primary control objectives requiring system/automated control activities for asset custody and typical controls are set out below.

A. Trades are authorized, recorded, settled, and reported completely, accurately, and timely and in accordance with the client agreement.
- The completeness of files of trades received from investment managers and custodians is verified based on header records.
- Edit and validation checks are performed to test the completeness and accuracy of trade information (settlement location, asset id, settlement date).
- Trades are pre-matched with counter parties prior to settlement.
- Trade exceptions are reported for follow up.
- Large dollar value trades are manually reviewed and authorized electronically.
- For redemption transactions, client level positions are checked to ensure that securities are held, before the instruction is released to the custodian.
- Unmatched settlement instructions are identified for investigation.
- Automated reconciliation and balancing of records received from depositories to those processed on in-house systems.
- The update of cash in client accounts is balanced to cash received/paid to the depositories.
• Reports of pending maturities of physically held maturities are produced to ensure securities are redeemed.

B. **Investment income is collected and recorded accurately on a timely basis.**
   • Income is automatically accrued and posted to client accounts based on holdings.
   • Where depositories provide files of projected income, that income is balanced to the custodian’s records.
   • Projected/accrued income is balanced to actual receipts from depositories.
   • Use of aged suspense accounts for income receivable (dividends and interest).

C. **Corporate actions are identified, processed, settled and recorded accurately on a timely basis.**
   • There is automated identification of corporate actions based on electronic feeds (e.g., from depositories).
   • Manually entered corporate actions are not processed until an independent review of supporting documentation, as evidenced by an electronic authorization, has been processed.
   • Distribution of corporate action notifications to, and receipt of instructions from, fund managers is electronically tracked. Overdue responses are automatically highlighted for follow up.
   • There is an automated update of holdings based on instructions received.

D. **The entity’s records accurately reflect securities held by third parties, for example, depositories or sub-custodians.**
   • Holdings of the custodian’s records are electronically reconciled to those of the depository/sub-custodian (e.g., through the receipt of SWIFT messages or electronic files).
   • There is electronic reconciliation of cash held at depositories.

If a custodian performs asset lending services for a fund, additional control objectives dealing with that function need to be established, for example, those set out below.

E. **Lender and borrower participation in lending programs is authorized.**
   • Edit checks ensure that securities are lent only to approved borrowers.

F. **Loan initiation, processing, maintenance and termination are recorded accurately on a timely basis.**
   • Edit checks validate proposed lending transactions against borrower and lender restrictions that have been recorded in the securities lending system.
   • The system automatically allocates securities borrowed to potential lenders in accordance with established criteria.
   • The system automatically identifies income receivable on loaned securities for follow up with borrower.
   • Overdue income is highlighted for follow up.
   • Cash received from borrowers in respect of income due is matched to the amount due.
   • Loan returns are monitored.

G. **Loans are adequately collateralized and collateral is recorded accurately on a timely basis.**
   • The value of collateral is valued daily based on standard price feeds.
   • The value of collateral is compared to the value of securities borrowed. Shortfalls in value are identified and additional collateral requested.
   • Collateral is invested in accordance with the lender agreement and income is calculated and distributed accurately on a timely basis.
FUND ACCOUNTING
The primary control objectives requiring system/automated control activities for fund accounting and typical controls include:

A. Controls provide reasonable assurance that securities costs are accurately calculated and recorded.
   - Transactional activity from trading systems (or electronic trade file) is automatically loaded to the fund valuation/ portfolio accounting system.
   - Exception reports are produced for failed trades (trades that did not load successfully to the fund valuation/ portfolio accounting system) and manually entered trades to enable manual review, follow up and re-input.
   - The system performs automated, exception-based reconciliations between custody system (or electronic file) positions (cash and securities) and positions in the fund valuation/ portfolio accounting system.
   - The system automatically calculates realized gains/losses and unrealized gains/losses.

B. Controls provide reasonable assurance that corporate actions and proxy voting instructions are identified and generated, and then processed and recorded accurately in a timely manner.
   - The operations team receives corporate action notifications detailing applicable accounts from the custodian electronically or by fax. Mandatory and voluntary corporate actions are systematically applied to client accounts by the operations team and reviewed by responsible staff.
   - Corporate action data vendor feeds used to retrieve mandatory corporate action notifications and holdings (in fund valuation/ portfolio accounting system security master) are automatically matched against corporate action events received from vendors.
   - The reporting team prepares monthly cash and security reconciliations with the custodian records and any corporate actions detected as a result, that the custodian has not yet flagged, are referred to the custodian for verification and follow up.

C. Controls provide reasonable assurance that investment income is complete, accurate and recorded in the proper period.
   - The system automatically posts dividend proceeds on ex-date (based on security master set-up) and the calculation of interest accruals/ amortization and dividends (based on rates set up in the fund valuation/ portfolio accounting system security master) to the general ledger.
   - The system automatically calculates the accrued interest income.
   - For global variable interest rate securities outsourced to a service provider, interest calculated by the system and the custodian calculation are reconciled monthly.
   - For fixed income securities, interest calculated by the system and the custodian calculation are reconciled monthly.
   - For segregated institutional accounts, on a monthly basis, system calculated accrued income is reconciled with the custodian’s calculations.
   - Where custodians do not report interest income, the reporting team reconciles the daily cash in the portfolio accounting system with the custodian’s.

D. Controls provide reasonable assurance that investments are priced using current prices obtained from independent external pricing sources.
- Prices files from vendors are automatically loaded to the fund valuation/portfolio accounting system and exception reports are automatically generated for missing prices (unpriced securities), stale prices, prices that have changed by more than a specific amount from the previous price and manually entered/modified prices.
- Independent external pricing sources automatically update the portfolio accounting system on a daily basis.
- The rates of return for all accounts are compared to an approved benchmark return for reasonableness.

E. **Controls provide reasonable assurance that cash and securities positions are completely and accurately recorded and reconciled to third-party data.**
- The operations group prepares daily reconciliations of the custodian’s bank account balances and the bank balances within the accounting systems.
- The operations group prepares daily reconciliations of the custodian’s and the accounting system’s security positions.
- For segregated institutional accounts, monthly reconciliations of security valuations (with the applicable custodian) are prepared.
- The system performs automated, exception-based reconciliations between sub-ledgers (purchases, redemptions, income, gains and losses) and the general ledger.

- The system performs automated, exception-based reconciliations between transfer agency (TA) system (or TA electronic feed) and outstanding units per the fund valuation/portfolio accounting system.

F. **Controls provide reasonable assurance that expenses are accurately calculated, and recorded in accordance with fund prospectus and contractual obligations.**
- The system calculates fee and expense accruals completely and accurately and accumulates them for posting to the general ledger. Calculations are based on authorized rates set up in the fund valuation/portfolio accounting system.

G. **Controls provide reasonable assurance that net asset values are accurately calculated.**
- The valuation/portfolio accounting system completely and accurately calculates the net asset value (NAV) for each fund and fund class.
- The system produces automated alerts/identification of out-of-tolerance amounts if the movement in the NAV is above predetermined thresholds.
- The system produces an automated NAV proof (detailing changes in NAV from prior day).
National Instrument 81-107 Independent Review Committee for Investment Funds has been in effect since November 1, 2007. Moving into the third year of the new governance regime, it is anticipated that fund managers and IRCs will reflect on the objectives of, and practical issues raised by, NI 81-107. Similarly, it is anticipated that the Canadian securities regulators will start conducting compliance reviews on NI 81-107. Fund managers, working with their IRCs, may find it beneficial to consider the following matters when assessing compliance with NI 81-107:

**Mandatory Steps Completed**

The review should confirm that the steps required under NI 81-107 have been taken.

1. First annual IRC report to securityholders posted and filed. Many IRCs should be starting to think about their second annual report, given that many mutual funds have December 31 financial year-ends. This second annual report must be filed and posted by the date that the funds file their annual financial statements (by March 30, 2009 for these funds).
2. Fund manager annual report provided to the IRC on the fund manager’s reliance on IRC standing instructions, including details about the “instances” that the manager relied on the standing instructions.
3. Annual review by the IRC of the “adequacy and effectiveness” of fund manager conflicts policies and procedures and IRC standing instructions and the required IRC report delivered to the manager.
4. IRC annual assessment of its effectiveness, overall and of each member, including a review of the IRC charter.
5. IRC annual assessment of its compensation and independence and IRC report on these issues provided to the manager.
6. At least one meeting of the IRC held, in whole or in part, in camera, with no representatives of the manager present.
7. IRC members provided with orientation on their role and the business of the fund manager.

**Year Two Review**

A fund manager conducting a second year review should consider the following fundamental questions and obtain feedback from its IRC, as appropriate.

1. Have the appropriate conflicts of interest matters (as that term is defined in NI 81-107) been identified? Given the broad principles-based definition of conflicts of interest matters, we believe that it is important to be largely consistent with industry practice in this area, although we also are of the view that reasonable people can disagree about whether a particular matter raises conflicts of interest. For example, in light of industry practice, it might be appropriate for a fund manager to decide that a particular matter is not a conflict of interest matter requiring IRC input, even if it has previously referred the matter to the IRC and vice versa.
2. Do its conflicts of interest policies and procedures accurately describe how it manages the applicable conflicts of interest? In particular, how does the fund manager deal with monitoring conflicts of interest when:
   - It is likely that significant conflict matters will arise in the course of the fund manager’s business activities.
   - It is likely that its conflicts of interest policies and procedures will need to be reviewed to ensure that they are adequately addressing the circumstances.

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58 Adapted with permission from the December 2008 Investment Management Advisory issued by Borden Ladner Gervais LLP.
interest of “entities related to the fund manager” as mandated by NI 81-107?

3. Does it have a policy and procedure in place to ensure on-going compliance with NI 81-107? Compliance with NI 81-107 means identifying how the Rule will be complied with in the future by the staff of a fund manager and constantly assessing whether any change to the fund manager’s business constitutes a conflict of interest matter.

4. Do IRC meetings run efficiently and with appropriate attention to the matters being considered? Does the IRC operate in a collegial and cooperative fashion? Are specific topics identified in an agenda for each meeting and are fund manager resources available to meet with the IRC on the scheduled dates to cover the specified topics? Is the communication between the fund manager and the IRC open and complete? Which officers of the fund manager should be in closest contact with the IRC? Should the IRC have access to, or hear from other representatives?

5. Do the IRC members understand the nature of the conflicts that have been referred to them and how they should provide on-going oversight over conflicts that are the subject of standing instructions? Do the IRC members understand the extent of governance provided by the fund manager over its funds – how the fund manager meets its fiduciary obligations? Do the IRC members need additional orientation and continuing education? If so, what resources are available from the fund manager?

6. Do the fund manager’s board, senior management and staff understand the nature and purpose of the oversight provided by the IRC? Is additional orientation and training necessary for the board, senior management and staff?

7. Should a different method of complying with the mandatory reporting under NI 81-107 be adopted? Does the IRC understand the reports and do they have time to complete their review?

8. Is the fund manager keeping track of industry-wide IRC compensation trends, so that it can make an informed recommendation to the IRC on future compensation?

9. Does the IRC have a process in place for filling vacancies and for succession planning, orientation of new members, keeping records of its meetings, and generally complying with the mandatory steps for IRCs under NI 81-107?

Lastly, is the IRC providing value to fund unitholders? If not, what changes can practically be made to enhance the value of the IRC? Depending on the results of its Year Two review, a fund manager may wish to make changes to its NI 81-107 compliance regime and discuss those changes with its IRC.
The terms defined in this Glossary are used in the Research Report or are commonly used in the investment funds industry and may be useful to the reader. Terms in bold within definitions are separately defined in the Glossary.

**Acronyms**

ADR – American Depository Receipt
AIF – Annual Information Form
AIMA – Alternative Investment Management Association
AIMR-PPS – Association for Investment Management and Research Performance Presentation Standards
CBOE – Chicago Board Options Exchange
CCIR – Canadian Council of Insurance Regulators
CCO – Chief Compliance Officer
CDS – Canadian Depository for Securities
CEO – Chief Executive Officer
CFAI – Chartered Financial Analysts Institute
CFO – Chief Financial Officer
CFTC – Commodity Futures Trading Commission
CICA – The Canadian Institute of Chartered Accountants
CIFP – Canadian Institute of Financial Planning
CompCorp – Canadian Life and Health Insurance Compensation Corporation
CRA – Canada Revenue Agency
CSA – Canadian Securities Administrators
DTC – Depository Trust Company
GAAP – Generally Accepted Accounting Principles
GDR – Global Depository Receipt
GIPS – Global Investment Performance Standards
IFIC – The Investment Funds Institute of Canada
IIROC – Investment Industry Regulatory Organization of Canada (The Investment Dealers Association of Canada and Market Regulation Services Inc. combined on June 8, 2008.)
IOSCO – International Organization of Securities Commissions
IRC – Independent Review Committee
ITA – Income Tax Act (Canada)
MBS – Mortgage-Backed Security
MFDA – Mutual Fund Dealers Association of Canada
MRFP – management report of fund performance prepared in accordance with NI 81-106
NAV – Net Asset Value

NYSE – New York Stock Exchange


NI 51-102 – National Instrument 51-102 – Continuous Disclosure Obligations


NI 52-201 – National Instrument 52-201 – Disclosure Standards


NI 81-102 – National Instrument 81-102 – Mutual Funds


NI 81-106 – National Instrument 81-106 – Investment Fund Continuous Disclosure


OSA – Ontario Securities Act

OSC – Ontario Securities Commission

OSFI – Office of the Superintendent of Financial Institutions (federal)

PBCR – Provincial Business Corporation Regulators

TSX – Toronto Stock Exchange
adviser. See investment adviser.

advisory and service fee (contract). The fee charged to an investment fund by its investment adviser, generally under a contract approved by vote of a majority of the fund’s shareholders / unitholders. The fee is generally calculated as a percentage of the average net assets, and may also include an additional bonus or penalty based on performance. (See incentive compensation.)

alpha. A numerical value indicating a fund’s risk-adjusted excess return relative to a benchmark. It also measures a fund manager’s “value added” in selecting individual securities.

amortization. In the context of a bond held as an asset, the systematic reduction of the difference between the price of a bond purchased at a discount or premium and the par value of the bond.

amortized cost. The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortization using the effective interest method of any difference between that initial amount and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectability.

annual information form (AIF). A disclosure document intended to provide disclosure about different matters than those discussed in the prospectus or simplified prospectus. A mutual fund follows Form 81-102F2, whereas a non-mutual fund that meets the definition of an investment fund looks to Part 9 of NI 81-106.

annual report. A financial report sent yearly to a publicly held firm’s shareholders.

arbitrage. The simultaneous purchase and sale of the same (or equivalent or related) securities to profit from short-term price differences prevailing in separate markets.

ask price. The lowest declared price for a security that a potential seller is willing to receive at a point in time.

as-of transaction. A purchase, redemption or exchange transaction processed on a retroactive basis. The effective date of the trade will be prior to the processing date. The difference in the share price between the “as-of” trade and the processing date could result in a gain or loss to a series (or shareholder) which may increase or dilute the assets of the series or any dividends paid by the series during the accumulation period.

asset allocation. Apportioning of investment funds among categories of assets, such as cash equivalents, stocks, and fixed income instruments.

averaging. (See dollar cost averaging.)

back-end load. A charge imposed on a shareholder / unitholder on redemption of shares / units. The charge generally is calculated on a sliding scale basis which declines over the duration of ownership. (See contingent deferred sales charge.)

balanced fund. An investment fund that invests in varying proportions of equity, fixed income and money-market securities for growth, income and temporary cash holding.

bank rate. The rate at which the Bank of Canada makes short-term loans to chartered banks and other financial institutions, and the benchmark for prime rates set by financial institutions.
bankers’ acceptance. Short-term bank paper with the repayment of principal and payment of interest guaranteed by the issuer’s bank.

basis point. A measure of interest rates. One basis point equals one hundredth of one percent (0.01%), or 10 cents per $1,000 per annum.

bear market. A prolonged period in which investment values decline, usually accompanied by pessimistic market expectations.

bear. A person who thinks that stock market prices will fall.

bearer bond. A long-term debt instrument that is not registered to a particular owner. The rights of ownership are retained by the holder of the instrument.

beta. A statistical term used to illustrate the relationship of the price of an individual security or mutual fund unit to similar securities or financial market indexes. A fund with a beta greater than 1.0 is more volatile than the market, while a fund with a beta of less than 1.0 is less volatile than the market.

bid price. The highest declared price for a security that a potential buyer is willing to pay at a point in time.

bifurcation. The separation of underlying factors relating to a transaction initially measured in one currency and reported in a second currency. Any difference between originally recorded amounts and currently consummated or measured amounts can be split into changes in the foreign exchange rate and changes in foreign currency denominated fair value.

block trading. The acquisition or disposition of large quantities (10,000 shares or more) or “blocks” of shares by a broker-dealer to facilitate the execution of buy and sell orders of customers, usually institutions. Often, a broker-dealer absorbs a portion of the order for its own account and risk.

blue chip. Common shares of a nationally known company that has a long record of profits, growth and dividend payments and a reputation for quality management, products and services.

board lot. A standard number of shares for trading transactions (usually 100 shares), although the number of shares varies with the price level of the security and the exchange it trades on.

bond discount. The difference between the face amount of a bond and the lower price paid by a buyer.

bond fund. An investment fund that invests primarily in fixed income securities, with the investment objective of producing income.

bond premium. The difference between the face amount of a bond and the higher price paid by a buyer.

bond. A debt instrument with the promise to pay a specified amount of interest and to return the principal amount on a specified maturity date.

book (entry) shares / units. Investment fund share / unit ownership evidenced by records maintained by a transfer agent rather than by physical share / unit certificates.

book value. The value of net assets that belong to a company’s shareholders, as stated on the balance sheet.

breakpoint. A volume of securities purchases that triggers a lower sales charge to take effect. It may also refer to the total amount of fund assets, which results in a lower investment advisory fee being charged.
broker. An agent, often a member of a stock exchange firm or an exchange member, who executes orders to buy or sell securities or commodities and charges a commission.

bull market. A period in which investment values increase, usually accompanied by optimistic market expectations.

bull. A person who thinks that stock market prices will rise.

bunching. This occurs when an investment adviser groups transactions in the same security for several clients to obtain lower commission charges and transaction costs.

buying on margin. Purchasing a security partly with borrowed money.

call option. A contract that entitles the holder to buy (call), at his or her option, a specified number of units of a particular security at a specified price (exercise price) either on (the European-style) or at any time until (the American-style) the stated expiration date of the contract. The option, which is transferable, is bought in the expectation of a price rise above the strike price. If the price rises, the buyer exercises or sells the option. If the price does not rise, the buyer lets the option expire and loses only the cost of the option. There is a listed and also an over-the-counter market in options. During the existence of an option, the exercise price and underlying number of shares are adjusted on the exercise date for cash dividends, rights, and stock dividends or splits. (See put option.)

callable. Redeemable by the issuer before the scheduled maturity. The issuer usually must pay the holders a premium price if such a security is retired early. Such securities are usually called when interest rates fall so much that the issuer can save money by floating new bonds at lower rates.

capital gain or loss. The profit or loss realized from the sale of capital assets, such as portfolio securities.

capital gains distribution. Dividends paid to investment fund shareholders / unitholders as a result of net capital gains realized on the disposition of portfolio securities or in the case of fund-on-fund investments, received from capital gain distributions of underlying funds.

capital stock. All ownership shares of a company, both common and preferred.

capital. Generally, the money or property used in a business. The term is also used to apply to cash in reserve, savings, or other property of value. capitalization. The total amount of all securities, including long-term debt, common and preferred stock, issued by a company.

cash equivalents. Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value.

cash sale. A sale with the same trade and settlement dates. The selling broker-dealer must be able to make delivery of the security sold on the trade date. The customer who is selling usually receives a discounted price on the sale for this special service.

cash. Refers to cash on hand and on deposit, in both domestic and foreign currency. It excludes cash subject to restrictions that prevent its use for current purposes or cash appropriated for other than current purposes, unless such cash offsets a current liability.
certificate. A document providing evidence of ownership of a security such as a stock or bond.

certificates of deposit. Negotiable savings instruments issued by a bank or other deposit-taking institution against funds deposited therewith. The instruments carry a specified rate of interest and maturity date.

churning. The practice of executing unnecessary purchases and sales of portfolio securities in a discretionary client account for the purpose of generating commissions.

clearing agency. A central location at which security transactions of members are matched to determine the minimum quantities to be received or delivered.

closed-end investment fund. An investment fund having a fixed number of nonredeemable shares / units outstanding. The shares / units are traded similarly to those of public corporations.

collateralized mortgage obligation (CMO). A mortgage-backed bond that separates mortgage pools into different classes called tranches. Each tranche is then sold separately. Repayment of each tranche is completed in the order specified in the prospectus.

commercial paper. Short-term, unsecured, promissory notes issued by banks and creditworthy corporations. Commercial paper is usually sold at a discount from face value.

Commodity Futures Trading Commission (CFTC). An agency established by the US Congress to regulate U.S. commodity futures markets and futures commission merchants. Among other things, this agency establishes rules governing the minimum financial, reporting and audit requirements of its members. Its function is similar to that performed by the SEC in regulating broker-dealers in securities and various securities markets.

common (collective) trust fund. An account maintained by the trust department of a bank or trust company for the pooling of investment funds of its own trust account customers.

common stock. A security representing ownership of a corporation’s assets. Voting rights are normally accorded to holders of common stock.

compounding. The process by which income is earned on income that has previously been earned. The end value of the investment includes both the original amount invested and the reinvested income.

constating documents. Legal documents (such as a charter, declaration of trust, or articles of incorporation) that establish the powers of an entity.

contingent deferred sales charge. A charge imposed against a shareholder / unitholder on redemption of shares / units. The charge generally is calculated on a sliding scale basis, which declines over the duration of ownership. (See back-end load.) contract difference. The difference between the contract and the market values of commodities.

contractual plan. An arrangement whereby an investor contracts to purchase a given amount of a security by a certain date and agrees to make partial payments at specified intervals.

control. A concept that is much broader than the traditional internal control over financial reporting, compliance and asset safeguarding. It encompasses all of the elements of an organization – its resources, systems, processes, culture, structure and tasks – that, taken
together, support people in achieving the organization’s objectives.

**convertible security.** A security that is convertible into another security based on a conversion rate, for example, a convertible preferred share that is convertible into common shares on a two-for-one basis.

**corporate actions.** An action by a company’s board of directors, including dividend declarations, reorganizations, mergers, and acquisitions.

**corporate bonds.** Debt instruments issued by corporations as distinct from those issued by government agencies or municipalities.

**corporation.** A legal business entity created under federal or provincial statutes. Because the corporation is a separate entity from its owners, shareholders have no legal liability for its debts. **coupon rate.** The annual interest rate of a bond.

**coupon stripping.** The practice of separating a bond certificate into its capital and its interest coupons, which are then sold separately.

**current value.** The market price or fair value of a security at the reporting date.

**current yield.** The annual rate of return that an investor purchasing a security at its market price would realize. This is the annual income from a security divided by the current price of the security. It is also known as the return on investment.

**custodian.** A bank, trust company or, less frequently, a member of a national securities exchange, that is legally responsible for receiving delivery and for the safekeeping of an investment fund’s securities and other assets.

**daily limits.** Limits established by exchanges to control fluctuations in the prices of futures contracts or other instruments during a trading session (other than the current month’s delivery contracts).

**dealer.** A person or firm acting as a principal rather than as an agent in buying and selling securities. Mutual fund shares or units are generally sold through dealers except where the fund sponsor has its own captive sales force (for example, a bank, trust company or life insurance company), or where the fund sponsor uses a direct marketing approach.

**debenture.** A bond unsecured by any pledge of property. It is supported by the general credit of the issuing corporation.

**declaration date.** The day on which the board of directors or the fund manager decides to make a dividend or distribution payment on a specified date to shareholders or unitholders of record on a specified record date. The amount of the dividend or distribution is usually specified on a per share / unit basis.

**deemed dividend.** A dividend not paid in cash or other consideration – an allocation of income that does not result in an increase in units and corresponding decline in price, but will result in a change to the adjusted cost base.

**deferral.** A form of tax sheltering that results from an investment that offers deductions during the investor’s high-income years, and/or postpones capital gains or other income until after retirement or during another period when the income level is expected to change.

**denomination.** The principal amount, or value at maturity, or a debt obligation. Also known as the par value or face value.
**derivative.** A financial instrument or other contract with all three of the following characteristics: (i) its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index, or other variable (sometimes called the “underlying”), provided in the case of a non-financial variable that the variable is not specific to a party to the contract; (ii) it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and (iii) it is settled at a future date.

**discount.** The amount by which a bond sells on the secondary market at less than its par value or face value.

**distributions.** Payments to unitholders from net investment income and realized capital gains. (See capital gains distribution and dividend.)

**distributor.** Usually the principal underwriter who sells the fund’s shares / units by acting as an agent (intermediary between the fund and an independent dealer or the public) or as a principal, buying shares / units from the fund at net asset value and selling them through dealers or directly to the public.

**diversification.** Investment of a portfolio in securities that have different kinds of investment risk, in order to moderate the portfolio’s overall risk of loss. Most commonly refers to diversification by securities issuer, but can also be used in reference to industry exposure, creditworthiness or quality of security issuers taken as a whole, or, in international portfolios, exposure to national (or regional) economies. Sometimes the term may be used in reference to security kinds (for example, fixed-income versus equity securities).

**dividend fund.** A mutual fund that invests in common shares of senior Canadian corporations with a history of regular dividend payments at above average rates, as well as preferred shares.

**dividend tax credit.** An income tax credit available to investors who earn dividend income through investments in the shares of Canadian corporations.

**dividend.** A per-share payment designated by a company’s board of directors to be distributed among shareholders. For preferred shares, it is generally a fixed amount. For common shares, the dividend varies with the fortunes of the company and the amount of cash on hand. It may be omitted if business is poor or the directors withhold earnings to invest in plant and equipment.

**dollar cost averaging.** Investing a fixed amount of dollars in a security at regular intervals over a period of time, thereby averaging the cost paid per unit / share.

**dual purpose fund.** A closed-end investment fund with two classes of shares / units – income shares / units for investors interested in income and capital shares / units for those interested in capital growth.

**equalization.** An accounting method used to prevent a dilution of the continuing shareholders’ / unitholders’ per share / unit equity in undistributed net investment income caused by the continuous sales and redemptions of capital shares / units.

**equity fund.** A mutual fund whose portfolio consists primarily of equity securities.

**equity securities.** Common and preferred shares, and debentures convertible into common shares.
**equity.** The net worth of a company. This represents the ownership interest of the shareholders (common and preferred) of a company. For this reason, shares are often known as equities.

**eurodollar.** US dollar deposits deposited in banks outside the United States, including foreign branches of American banks.

**exchange.** An organized forum, that can be a physical or electronic location, for the trading of securities or commodities by members for their own accounts or the accounts of their customers. Examples of securities exchanges are the Toronto Stock Exchange (TSX), the Toronto Venture Exchange (TSX-V) and the New York Stock Exchange (NYSE).

**ex-dividend or ex-distribution.** Shares that are traded without dividend or without a distribution. The buyer of a share selling ex-dividend does not acquire a right to receive a previously declared but unpaid dividend. Dividends are payable on a fixed date to shareholders recorded on the stock transfer books of the disbursing company as of a previous date of record. (See record date.) In the case of nontraded shares / units of mutual funds, the ex-dividend date is usually the same as the record date.

**ex-rights.** Similar to ex-dividend. The buyer of a share selling ex-rights is not entitled to a rights distribution.

**ex-warrants.** Shares or bonds trading without attached warrants.

**face value.** The principal amount, or value at maturity, of a debt obligation. Also known as the par value or denomination.

**fail to deliver.** Occurs when the selling broker or other financial institution has not delivered the securities to the buyer at the settlement or clearance date of the transaction.

**fail to receive.** Occurs when the buying broker or a financial institution has not received the securities from the seller at the settlement or clearance date of the transaction.

**fair value.** The amount of the consideration that would be agreed upon in an arm’s length transaction between knowledgeable, willing parties who are under no compulsion to act.

**fiduciary.** An individual or institution that holds assets in trust for another individual or institution. An executor, administrator or trustee. Hence, “fiduciary” duties.

**fiscal policy.** The policy pursued by government to manage the economy through its spending and taxation powers.

**fixed-period withdrawal plan.** A plan through which the mutual fund investor’s holdings are fully depleted through regular withdrawals over a set period of time. A specific amount of capital, together with accrued income, is systematically exhausted.

**forward exchange contract.** An agreement to exchange currencies of different countries at a specified future date at a specified rate (the forward rate). Unlike a securities futures contract, the terms of a forward contract are not standardized.

**front-end load.** A charge imposed on a unitholder / shareholder on the purchase of units / shares sold by brokers or other members of a sales force. The charge is deducted from the amount to be invested in the fund’s units / shares.
fund of funds. An investment fund that invests in securities of other investment funds.

fund manager. A fund manager generally provides investment advice, research services and certain administrative services under a contract, commonly referred to as a management agreement, for a management fee that is based on a percentage of average net assets and, possibly, includes an incentive fee based on performance results.

fundamental analysis. A method of evaluating the future prospects of a company by analyzing its financial statements. It may also involve interviewing the management of the company.

futures contract. An agreement to buy or sell, at a specified future date and price, a specified quantity of commodity, currency or financial instrument.

growth fund. An investment fund investing primarily in growth industry securities, emphasizing future capital appreciation over current yield.

growth stocks. Shares of companies whose earnings are expected to increase at an above-average rate. Growth stocks are often typified by their low yields and relatively high price/earnings ratios. Their prices reflect investors’ belief in their future earnings in growth.

guaranteed investment certificates. A deposit instrument sold by Canadian banks and trust companies paying a predetermined rate of interest for a specified term.

hedging. The use of transactions to reduce existing market, interest rate or foreign currency risks. Hedging techniques include the use of futures, swaps and options to offset a present or anticipated position of risk.

holder of record. The party listed as the registered owner on the transfer records of a corporation.

illiquid. Not readily convertible into cash, such as a stock, bond, or commodity that is not actively traded, and would be difficult to sell in a current sale.

incentive fee or incentive compensation. A fee paid to an investment adviser based upon the fund’s performance for the period. The fee generally consists of a basic fee plus a bonus (or less a penalty) if the fund’s performance exceeds (or fails to match) that of a specified benchmark.

income funds. Mutual funds that invest primarily in fixed-income securities such as bonds, mortgages and preferred shares. Their primary objective is to produce income for investors, while preserving capital.

independent review committee (IRC). A fully independent body that must be established by a reporting issuer in accordance with NI 81-107 to oversee all decisions involving an actual or perceived conflict of

hedge fund. An investment fund seeking to minimize market risks by holding securities believed likely to increase in value and, at the same time, being short in securities believed likely to decrease in value. These funds use investment strategies such as leverage and long, short and derivative positions. The only objective is capital appreciation.
interest faced by the fund manager in the operation of the fund.

**index fund.** A mutual fund that matches its portfolio to that of a specific financial market index, with the objective of duplicating the general performance of the market in which it invests.

**index option.** Calls or puts on indexes of stock.

**index.** A statistical composite that measures changes in the economy or in financial markets. In the case of financial markets, an index is a portfolio of securities representing a particular market or a portion of it. Each index has its own calculation methodology and is usually expressed in terms of a change from a base value.

**indexed security.** A security whose value is based on the absolute or relative value, over a period of time or at a point in time, of a financial indicator, such as a measure of interest rates, exchange rates, commodity prices, or stock prices.

**indexing.** Weighting a portfolio to match a broad-based index so as to match its performance.

**individual variable insurance contract (IVIC).** An individual contract of life insurance, including an annuity, or an undertaking to provide an annuity, as defined by provincial and territorial insurance statutes and by the Civil Code of Quebec, under which the liabilities vary in amount depending upon the market value of a specified group of assets in a segregated fund, and includes a provision in an individual contract of life insurance under which policy dividends are deposited in a segregated fund.

**initial margin deposit.** The amount of money or its equivalent in securities, that is held as a good-faith deposit when entering into a commodity transaction to make sure that the customer meets the variation margin requirement. The amount is usually specified by the exchange on which the commodity is traded. Maintenance margin refers to additional deposits. (See margin.)

**international fund.** A mutual fund that invests in securities of a number of countries.

**intrinsic value.** The amount by which the price of a warrant or call option exceeds the price at which the warrant or option may be exercised.

**inverse floater.** A floating rate note in which the rate paid increases (decreases) at a multiple of declines (rises) in the specified floating market rate.

**investment adviser.** A person or company providing investment advice, research and, often, administrative and similar services for a contractually agreed-on fee, generally based on a percentage of net assets. (See fund manager.)

**investment advisory agreement.** An agreement between an investment fund and an investment manager, engaging the investment manager to provide investment advice to the investment fund for a fee.

**investment company.** An investment company is either: (a) an investment fund as defined by the Canadian securities regulatory authorities in National Instrument 81-106, Investment Fund Continuous Disclosure; 1 or (b) a separate legal entity whose primary business activity for the period is investing. All of the following must apply for an enterprise’s primary business activity to be investing: (a) The enterprise’s expressed business purpose is to be an investment company that holds investments for current income, capital appreciation, or both. (b) The enterprise has no substantive activities other than its investment activities and no significant assets or liabilities
other than those related to its investment activities, except for operating activities related to services provided to investment companies. (c) The enterprise does not obtain, or have the objective of obtaining, benefits from its investments that are unavailable to unrelated non-investor enterprises and that are not normal benefits attributable to an ownership interest (such as dividends). Such benefits might include, for example, access to processes, intangible assets or technology of the investee; guarantees provided by an investee to benefit the investor; or other transactions that are not at fair value. (d) The enterprise or its affiliates are not involved in the day-to-day management of investees, affiliates of investees, or other investment assets. That requirement may be met, however, if management of the enterprise or its affiliates is represented on the boards of directors of investees or affiliates of investees, or provides limited assistance to management of investees or affiliates of investees for a short period. (e) For each investment, the enterprise has an exit strategy that involves the transfer of the enterprise’s ownership interest to unrelated third parties. An exit strategy includes methods of exiting the investment and the time when this is expected to occur, which might, for example, be expressed as a time period or when certain conditions or targets have been met.

**investment counsel.** A firm or individual which furnishes investment advice for a fee.

**investment dealer.** A securities firm.

**investment fund.** An entity that offers its shares / units for sale to a wide group of investors. The capital raised is invested in accordance with the fund’s investment policies and objectives. Income is earned through interest, dividends and capital gains. An investment fund makes investments on behalf of individuals and institutions with similar financial goals on a “pooled” basis. Investment funds include: “open-end mutual” funds, which are generally prospectus-exempt and invested in by institutions and high-net-worth investors; “segregated” funds, which are managed by life insurance companies; “closed-end” funds, which are generally listed on a recognized stock exchange; and “partnerships and limited partnerships,” which carry on the business of pooled investing on behalf of the partners.

**Investment Funds Institute of Canada (IFIC).** The mutual fund industry trade association set up to serve its members, co-operate with regulatory bodies, and protect the interests of the investing public that use mutual funds as a medium for their investments.

**investment grade bonds.** Bonds rated by a rating service in one of its top four categories (for example, AAA to BBB/Baa).

**investment objective.** The goal, such as long-term capital growth, current income, growth and income, etc., that an investor or a fund pursues. Each fund’s objective is stated in its prospectus or other offering document.

**investment partnership.** A partnership, usually a limited partnership, organized to invest and trade in securities.

**issued shares.** The number of securities of a company outstanding. This may be equal to or less than the number of shares a company is authorized to issue.

**junk bonds.** Bonds with a rating of BB/Ba or lower, issued by a company without a long record of sales and earnings or with questionable credit strength. Common kinds include step-interest, and payment-in-kind bonds. Also known as high-yield bonds.

**labour sponsored or venture capital fund.** An investment fund that is (a) a labour sponsored investment
fund corporation or a labour sponsored venture capital corporation under provincial legislation, (b) a registered or prescribed labour sponsored venture capital corporation as defined in the Income Tax Act, or (c) in British Columbia, an employee venture capital corporation or a venture capital corporation.

**lapping.** The timing differences between a trade date and the settlement date, when a mutual fund client’s money held for a trade that has not yet been settled is used to settle a trade for another mutual fund client who has not provided adequate money to cover the settlement of that other trade on the settlement date.

**late trading.** This is illegal and occurs when purchase or redemption orders are received after the close of business, but are filled at that day’s price rather than the next day’s price. Late trading is a violation of National Instrument 81-102.

**letter of intent.** An agreement whereby an investor agrees to make a series of purchases of mutual fund units.

**leverage.** The use of various financial instruments or borrowed capital (for example, buying securities to increase the potential return of an investment.

**LIBOR (London Interbank offered rate).** The rate of interest that the most creditworthy international banks dealing in eurodollars charge each other for large loans. Various instruments’ rates are tied to LIBOR.

**liquidity.** Measure of the ease with which a security trades in large blocks without a substantial drop in price.

**listed security.** A security listed and traded on a stock exchange.

**load.** Commissions charged to holders of mutual fund units. (See sales charge.)

**long position.** Denotes ownership or right to possession of securities, or holding a commodity or security in anticipation of a rise in price.

**management company.** The entity within a mutual fund complex responsible for the investment of the fund’s portfolio and/or the administration of the fund. It is compensated on a percentage of the fund’s total assets.

**management expense ratio.** The ratio, expressed as an annualized percentage, of the expenses of an investment fund to its average net asset value, calculated in accordance with Part 15 of NI 81-106.

**management fee.** The total fees paid or payable by an investment fund to its manager or one or more portfolio advisers or sub-advisers, including incentive or performance fees, but excluding operating expenses of the investment fund.

**management report of fund performance (MRFP).** An annual or interim management report of fund performance prepared in accordance with NI 81-106.

**margin accounts.** A means of leveraging offered by brokers or dealers to permit their customers to buy securities partly with borrowed funds. The broker or dealer lends the customer the difference between the price of a security and the equity provided by the customer.

**margin.** The amount of money or its equivalent in securities that a customer must deposit with a broker in a securities transaction on margin. (See initial margin deposit.)
**mark to market.** A procedure used to adjust the carrying value of a security to current value at the reporting date.

**market index.** A vehicle used to denote trends in securities markets. A market index can be used as a proxy to represent an entire market or a segment of a market. The most popular index in Canada is the Toronto Stock Exchange’s S&P/TSX Composite Index (TSE 300).

**market price.** The last reported selling price for a security. If the security has not been traded or if the selling price has not been reported, market price is based on recent bid and ask prices.

**market timing.** This involves short-term trading of mutual fund securities to take advantage of short-term discrepancies between the price of a mutual fund’s securities and the stale values of the securities within the fund’s portfolio. International funds are most vulnerable to this type of trading abuse, as traders can exploit differences between time zones. Where it happens, market timing may be in violation of mutual fund policies. Further, the heavy trading creates transaction costs, which reduces returns of other longer term investors. As such, market timing arrangements may be in violation of a fund manager’s fiduciary duty, for example, under section 116 of the *Ontario Securities Act.*

**market value.** Means (i) as to cash, the amount; and (ii) as to a security held by a fund, the current price obtained from a generally recognized source, the most recent bid quotation from a generally recognized source or, if no generally recognized source exists, the price for the security as determined by data and assumptions documented by the parties to a transaction, and accrued but unpaid income on the security.

**material contract.** For an investment fund, a document that the investment fund would be required to list in an annual information form under Item 16 of Form 81-101F2 if the investment fund filed a simplified prospectus under NI 81-101.

**materiality.** Users are interested in information that may affect their decision making. Materiality is the term used to describe the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the particular circumstances.

**matrix pricing.** A statistical technique used to value normal institutional size trading units of debt securities without relying exclusively on quoted prices. Factors such as the issue’s coupon or stated interest rate, maturity, rating and quoted prices of similar issues are considered in developing the issue’s current market yield. (See *fair value.*)

**maturity.** The date at which a loan or bond or debenture comes due and must be redeemed or paid off.

**money market fund.** An investment fund whose investments are primarily or exclusively in short-term debt securities designed to maximize current income with liquidity and capital preservation, usually maintaining per share / unit net asset value at a constant amount, such as one, five or 10 dollars.

**money market instruments.** Short-term investments such as treasury bills and other government obligations, commercial paper, bankers acceptances and certificates of deposit with a term to maturity of 365 days or less.

**money market.** A sector of the capital market where short term obligations such as Treasury bills, commercial paper and bankers’ acceptances are bought and sold.
**mortgage backed security (MBS).** An asset backed security issued on a pool of underlying mortgages. Created by pooling mortgages and selling interests or participation in the MBS. The mortgage originator usually continues to service the underlying mortgages while passing principal and interest payments received from the mortgagors through to the MBS holders.

**mortgage fund.** A mutual fund that invests in mortgages. Portfolios of mortgage funds usually consist of first mortgages on Canadian residential property, although some funds also invest in commercial mortgages.

**municipal notes and bonds.** Securities that are issued by cities and other local government authorities to fund public projects.

**mutual fund.** An investment entity that pools shareholder or unitholder funds and invests in various securities. The units or shares are redeemable by the fund on demand by the investor. The value of the underlying assets of the fund influences the current price of units.

**NASDAQ.** An electronic quotation system for securities sponsored by the National Association of Securities Dealers (NASD) in the US which, for securities traded on the NASD National Market System, reports prices and shares or units of securities trades in addition to other market information.

**National Association of Securities Dealers, Inc. (NASD).** An association of brokers or dealers in the US, registered as such under section 15A of the Securities Exchange Act, that supervises and regulates trading conducted by its members.

**net asset value (NAV).** The value of the total assets of the investment fund less the value of the total liabilities of the investment fund, as at a specific date, determined in accordance with Part 14 of NI 81-106. This is the value to be used for all purposes other than financial statements (for example, purchases and redemptions of the investment fund’s securities).

**net asset value per security (NAV per security).** The value per unit / share of an investment fund, calculated by dividing the net asset value by the total number of shares / units outstanding.

**net assets.** The amount determined under Canadian GAAP, which is the amount to be used for financial statements and certain information derived from the financial statements (for example, certain disclosure in the management reports of fund performance). It is the value at the beginning of the year based on the audited annual financial statements plus (or minus) the increase (or decrease) from operations, less annual distributions.

**New York Stock Exchange (NYSE).** A not-for-profit corporation that is the largest securities exchange in the United States. This self-regulatory organization also furnishes facilities for its members, allied members, member firms, and member corporations to aid them in conducting securities business.

**no-load fund.** An investment fund that sells its shares / units without adding front-end or back-end sales charges.

**non-redeemable investment fund.** An issuer, (a) whose primary purpose is to invest money provided by its securityholders, (b) that does not invest, (i) for the purpose of exercising or seeking to exercise control of an issuer, other than an issuer that is a mutual fund or a non-redeemable investment fund, or (ii) for the purpose of being actively involved in the management of any issuer in which it invests, other than an issuer that is a mutual fund or a non-redeemable investment fund, and (c) that is not a mutual fund.
**odd lot.** Refers to a quantity of securities that is less than an even 100 shares or less than the established trading unit of that security in a particular securities market.

**offering price.** The price at which mutual fund shares or investment trust units can be bought, often equaling net asset value per share plus a sales load.

**offset.** A closing transaction involving the purchase or sale of an option having the same features as one already held. A hedge, such as a short sale of a share to protect capital gain, or the purchase of a futures contract to protect a commodity price, or a straddle representing the purchase of offsetting put and call options on a security.

**offshore fund.** An investment company organized outside the country of domicile, whose shares are offered solely to foreign investors.

**open contract.** An unperformed or unsettled contract. May be used in referring to new issues traded when, as, and if issued or in referring to commodity futures trading. The term is used to designate contracts bought or sold, still outstanding, or delivered or offset.

**open-end investment fund.** An investment fund whose capitalization is generally not fixed or limited in any way, that is ready to redeem its shares / units at any time and that usually offers its shares / units for sale to the public continuously.

**option.** The right or obligation to buy or sell a specific quantity of a security at a specific price within a stipulated period of time.

**OTC (over-the-counter).** A market for securities of a company not listed on a stock exchange and traded mainly by electronic communications or by phone between brokers and dealers who act on behalf of customers.

**par value.** The principal amount, or value at maturity, of a debt obligation. It is also known as the denomination or face value. Preferred shares may also have par value, which indicates the value of assets each share would be entitled to if a company were liquidated.

**payable date.** The date on which a dividend / distribution is payable to holders of record on some previous record date.

**point.** A rise or decline of one dollar per share, used to refer to the purchase or sale of shares. If used for the purchase or sale of bonds, the term means a rise or decline of $10 per $1,000 principal amount. A basis point is one hundredth of one percent of the principal amount.

**portfolio turnover rate.** A measure of portfolio activity, generally calculated for an investment fund by dividing the lesser of purchases or sales of securities, excluding securities having maturity dates at acquisition of one year or less, by the average value of the portfolio securities held during the period. Refer to the full calculation in Instruction (i) in Part B, item 3.1 of Form 81-106F1.

**portfolio.** Securities owned by an investment fund.

**preferred share.** A share with rights that are preferential to those of a common share. In determining whether shares are common shares or preferred shares, it is the rights of the shares in relation to earnings rather than their legal designation that govern.

**premium.** The amount by which a bond’s selling price exceeds its face value. Also, the amounts paid to keep an insurance policy in force.
**present value.** The current worth of an amount to be received in the future. In the case of an annuity, present value is the current worth of a series of equal payments to be made in the future.

**price-earnings ratio (P/E ratio).** The market value of a share of stock divided by its earnings per share.

**primary distribution.** A new security issue, or one that is made available to investors for the first time. This is also called a primary offering or initial public offering (IPO).

**principal.** The person for whom a broker executes an order, or a dealer buying or selling for his or her own account. Also, an individual’s capital or the face amount of a bond.

**private placement.** The direct sale of a block of securities of a new or secondary issue to a single investor or group of investors.

**prospectus.** A document that describes the securities being offered for sale by an investment fund. In Canada, a simplified prospectus is used by mutual funds. This prospectus contains information required by the securities regulators, such as the fund’s investment objectives and policies, services, how shares / units are bought and redeemed, fund fees, and risk. (See simplified prospectus.)

**proxy statement.** A publication sent to securityholders by a fund manager, a board of directors, or its adversaries, or others, usually containing financial reports (for merger and other financial proposals), stockholders’ meeting notices and voting information on certain matters to solicit proxies from the holders.

**proxy.** A person authorized to vote the shares / units of an absent shareholder / unitholder at a meeting of shareholders / unitholders. It also refers to the written authorization given to that person.

**purchase warrants.** See warrants.

**put option.** A contract that gives the holder the option to sell (put) the underlying security, at a specified price (exercise price), either on (the European style) or at any time until (the American style) the contract’s stated expiration date. The put option is bought in the expectation of decrease in the price of the underlying security below the exercise price. If the price declines, the buyer generally exercises or sells the option. If the price does not decline, the buyer lets the option expire and loses only the premium paid for the option. There are both listed and over-the-counter markets in options. The exercise price and number of shares of an option are adjusted on the ex-date for cash dividends, rights and stock dividends or splits. (See call option.)

**quarterly portfolio disclosure.** A summary of an investment fund’s investment portfolio prepared in accordance with Part B, item 5 of Form 81-106F1 for a period of three months at the end of the first or third quarter. Must be posted on an investment fund’s website, if applicable (see Part 6 of NI 81-106).

**ratio withdrawal plan.** A type of mutual fund withdrawal plan that provides investors with an income based on a percentage of the value of units held.

**real estate fund.** A mutual fund that invests primarily in residential and/or commercial real estate to produce income and capital gains for its unitholders.

**real estate investment trust.** A closed-end investment company that specializes in real estate or mortgage investments.
real return bond. A government bond that pays interest semi-annually based on inflation-adjusted principal and, at maturity, repays the principal in inflation-adjusted dollars.

realized gain or loss. See capital gain or loss.

record date. The date on which an owner of a share must be registered on the books of a company as a shareholder to receive a declared dividend / distribution or, among other things, to vote on company affairs.

recordkeeping agent. A service bureau, bank, or other agency engaged by an investment company to maintain records of purchases and sales of investments, sales and redemptions of fund shares, and shareholders’ account statements.

redeemable. Preferred shares or bonds that give the issuing corporation an option to repurchase securities at a stated price. These are also known as callable securities.

redemption fee. A percentage of net asset value that may be charged to the investor on redemptions.

redemption in kind. Redemption of investment fund shares / units by payment in portfolio securities, not cash.

redemption or repurchase price. The price, generally net asset value less a redemption fee (if applicable), at which a share / unit of an investment fund is redeemed or repurchased.

redemption. A shareholder’s / unitholder’s tender of investment fund shares / units to the fund or agent designated by the fund, requiring liquidation of such shares / units in exchange for proceeds, usually in cash, representing the net asset value of the shares / units tendered (less any redemption fee).

registered owner. The owner of a security whose name is recorded on the face of the certificate and on the books of the issuing fund or its agent.

registrar. Generally, a banking institution that countersigns share / unit certificates and is responsible for preventing the issuance of more shares / units than authorized by the board of directors and the charter of the issuing fund. (See transfer agent.)

registration of transfer. Usually refers to the act of recording a transfer of ownership of registered securities on the transfer books of the issuing corporation, and issuing new certificates to the new registered owner. It is not part of the transfer itself. (See transfer.)


repurchase agreement (repo). An agreement under which an investment fund transfers (sells) securities for cash to another party (purchaser), usually a broker, and agrees to repurchase them within a specified time at a specified price. (A repurchase agreement is known on the side of a buying broker-dealer or other buyer as a reverse repurchase agreement.)

repurchase. Liquidation of investment fund shares / units through a distributor or a broker-dealer on behalf of shareholders / unitholders, sometimes for a purchase or service charge or a brokerage commission.
restricted security. A portfolio security that may be sold privately, but that is required to be registered with a regulatory authority or to be exempted from such registration before it may be sold in a public distribution.

glossary

retractive. Bonds or preferred shares that allow the holder to require the issuer to redeem the security before the maturity date.

return of capital. Distributions by investment companies in excess of tax-basis earnings and profits.

return. See yield.

reverse repurchase agreement (reverse repo or resale). An agreement under which an investment fund pays for and receives (purchases) securities from a seller who agrees to repurchase them within a specified time at a specified price. (A repurchase agreement is known on the side of a selling broker-dealer or other seller as a repurchase agreement.)

rights. Options granted to shareholders to purchase additional shares directly from the company concerned. Rights are issued to shareholders in proportion to the securities they may hold in a company.

risk. The possibility that one or more individuals or organizations will experience adverse consequences from an event or circumstance.

round lot. A unit of trading, or a multiple of it, generally established by each particular exchange.

sales charge. In the case of mutual funds, these are commissions charged to holder of fund units, usually based on the purchase or redemption price. Sales charges are also known as “loads.”

Securities Act of 1933. The principal US federal law regulating the public offering of corporate securities. Among other things, regulates contents of prospectuses and similar documents and is intended to ensure that potential investors receive adequate information to make reasonably informed investment decisions.

securities legislation. Provincial legislation regulating the underwriting, distribution and sale of securities.


securities lending. The practice of lending portfolio securities, usually to a broker to cover a short sale. The loan is usually collateralized by cash or government securities.

seed money. An initial amount of capital contributed to a company at its inception.

segregated fund. A pool of assets owned by a life insurance company and held separate and apart from other similar pools and its general assets. An individual variable insurance contract (IVIC) gives a purchaser the right to choose among various segregated funds that will give the purchaser specified benefits based on the value of the chosen segregated funds. (See individual variable insurance contract (IVIC).)

seller’s option. A transaction that by agreement is to be settled at a date later than the usual regular-way transaction.
**senior equity security.** Any stock of a class having a priority over any other class as to distribution of assets or payment of dividends.

**separate account.** An account established and maintained by an insurance company that holds particular assets allocated to that account, and is credited or charged with income, gains or losses from these assets separately from income, gains or losses of the insurance company’s corporate or other accounts. A separate account may also be called a “variable account” when the assets are held on behalf of variable annuities or variable insurance policies.

**series.** Different classes of shares set up by an investment fund to differentiate expenses and distributions – targeted to different types of investors in the fund. Also referred to as classes.

**settlement date.** The date that an asset is delivered to or by an entity. Settlement-date accounting refers to: (a) the recognition of an asset on the day it is received by the entity; and (b) the derecognition of an asset, and recognition of any gain or loss on disposal, on the day that it is delivered by the entity. When settlement-date accounting is applied, an entity accounts for any change in the fair value of the asset to be received during the period between the trade date and the settlement date in the same way as it accounts for the acquired asset. In other words, the change in value is not recognized for assets carried at cost or amortized cost, it is recognized in net income for assets classified as held for trading, and it is recognized in other comprehensive income for assets classified as available for sale.

**shareholder (unitholder) of record.** A shareholder / unitholder whose name is registered on the share / unit transfer books of the issuing corporation.

**shareholders’ equity.** The amount of a corporation’s assets belonging to its shareholders (both common and preferred) after allowance for any prior claim.

**shares.** A document signifying part ownership in a company. The terms “share” and “stock” are often used interchangeably.

**short position.** With respect to: (i) clearing corporation financial options, over-the-counter financial options and listed warrants, refers to a fund having a position which, at the election of another, obliges the fund to purchase, sell, receive or deliver the underlying interest (or pay or receive cash in lieu thereof); (ii) futures and forward contracts, refers to a fund holding a position which obliges the fund to deliver the underlying interest (or pay or receive cash in lieu thereof); (iii) call financial options on futures, refers to a fund holding a position which, at the election of another, obliges the fund to assume a short position in futures; and (iv) put financial options on futures, refers to a fund holding a position which, at the election of another, obliges the fund to assume a long position in futures.

**short sale.** A sale of securities not owned at the time of sale anticipating the price to fall and the securities to be repurchased at a profit. A person selling short borrows equivalent securities to deliver to the buyer and eventually buys the securities to return to the lender.

**simplified prospectus.** An abbreviated and simplified prospectus distributed by mutual funds to purchasers and potential purchasers of units or shares, which follows Form 81-101F1. (See prospectus.)

**special warrants.** See warrants. **specialty fund.** A mutual fund that concentrates its investments on a specific industrial or economic sector or a defined geographical area.
spread. A combination of a put and call option at different prices, one below and the other above the current market price. Also refers to the difference between the bid and asked prices of a security and to the dealer's commission on a security offering.

stapled unit. A unique form of security that combines the attributes of common shares, preferred shares and debt in a single security. These are “stapled” together as a single unit that trades in the stock market.

step bond. A type of high-yield debt instrument with deferred interest payments, or whose interest rate resets at specific times during its term.

stock dividend. A dividend payable in the stock of the issuing corporation.

stock options. Rights to purchase a corporation’s stock at a specified price.

stock split. An increase in the number of outstanding shares of a company’s stock to decrease the market price and thus allow for greater distribution of the shares. For example, ownership of two shares for each share previously held tends to reduce the price of each share by approximately half, assuming no other concurrent changes, such as in the rate of dividend.

stockholder (unitholder) of record. A unitholder / stockholder whose name is registered on the unit / share transfer books of the issuing corporation.

stop order. An order a customer places to protect a paper profit in a security or to keep down a possible loss in a security. The stop order becomes a market order when the price of the security reaches or sells through the price specified by the customer. Also called a stop loss order.

straddle. A combination of one put and one call option, identical to the security issue, number of shares, exercise price and expiration date.

strip bonds. The capital portion of a bond from which the coupons have been stripped. The holder of the strip bond is entitled to its par value at maturity, but not the annual interest payments.

structured note. A type of debt instrument with a customized coupon that pays based on equal, proportional or leveraged increases (or decreases) in interest or currency rates, commodity indexes or specific securities’ fair values.

swaps. A series of forward contracts which obligate two parties to swap or exchange a series of cash flows on specified payment dates. The cash flows are either fixed or calculated by specified reference rates or prices. Interim payments are netted, with the difference being paid by one party to the other.

syndicate. A group of brokers or dealers who together underwrite and distribute new issues of securities or large blocks of an outstanding issue.

synthetic coupon security. A security created by the combination of two or more other securities.

synthetic floaters. A derivative instrument which uses interest payments from long-term municipal bonds, which may be coupled with an interest rate swap and put features, to pay a floating short-term interest rate.

systematic withdrawal plan. Plans offered by mutual fund companies that allow unitholders to receive payment from their investment at regular intervals.

technical analysis. A method of evaluating future security prices and market directions based on
statistical analysis of variables such as trading volume, price changes, etc., to identify patterns.

**tender offer.** A public offer to buy from stockholders not less than a specified number of shares of stock at a fixed price, usually in an attempt to gain control of the issuing company.

**ticker.** An instrument that displays the price and quantity of a security traded on an exchange within minutes after the trade has been executed.

**TMX Group Inc.** Operates Canadian exchanges trading equities and derivatives, including the Toronto Stock Exchange (TSX), the TSX Venture exchange (TSX-V) and the Montreal Exchange.

**total return.** A periodic measure of a fund’s overall change in value, which assumes the reinvestment of net investment income distributions / dividends and capital gain distributions.

**trade date.** The date that an entity commits to purchase or sell an asset. Trade-date accounting refers to: (a) the recognition of an asset to be received and the liability to pay for it on the trade date; and (b) derecognition of an asset that is sold, recognition of any gain or loss on disposal, and the recognition of a receivable from the buyer for payment on the trade date. Generally, interest does not start to accrue on the asset and corresponding liability until the settlement date, when title passes.

**trade.** An agreement of purchase and sale to be settled by payment and delivery on a settlement date.

**trading expense ratio.** Represents total commissions and other portfolio transaction costs of an investment fund expressed as an annualized percentage of daily average net asset value during the period (see Part B, section 3.1, item (1) of Form 81-106F1).

**trading unit.** The unit by which the security is traded on the exchange, usually 100 shares of stock or an even monetary value of bonds. Also called a **round lot.**

**transfer agent.** An agent, acting on behalf of a company, who keeps records of the names of a company’s or investment fund’s registered shareholders or unitholders, their addresses and the number of shares or units they own. (See **registrar.**)

**transfer.** A change of ownership of a security by delivery of certificates for the security in a sale (against payment of the purchase price in a securities market sale), or by gift, pledge or other disposition. A subsequent registration of the transfer in the securities transfer records of the issuer is not a part of the transfer itself.

**treasury bill (T-bill).** Short-term government debt that bears no interest but is sold at a discount. The difference between the discount price and par value is the return to be received by the investor.

**trust.** An instrument placing ownership of property in the name of one individual or entity, called a trustee, to be held by the trustee for the use and benefit of some other person.

**trustee.** An individual or institution holding property in trust for the benefit of another.

**underwriter.** An investment firm that purchases a security directly from its issuer for resale to other investment firms or the public or sells for such issuer to the public.

**underwriting.** The act of distributing a new issue of securities or a large block of issued securities – that is, a secondary offering, commonly including an obligation to purchase the underwritten securities, regardless of whether they can be resold to others. unit investment trust. An investment company, organized under a trust
indenture, that issues only redeemable securities, each of which represents an undivided interest in a unit of specified (usually unmanaged) securities.

unit trust. An unincorporated fund whose organizational structure permits the conduit treatment of income realized by the fund.

unlisted security. A security that is not listed on a securities exchange. (See OTC (over-the-counter).)

unrealized appreciation or depreciation. The excess (appreciation) or deficiency (depreciation) of the value of securities over (under) their cost.

variation margin. A term used in commodity operations. Refers to last-day point fluctuation — a difference between the settling price of the day before and the last day’s settling price on net positions long and short.


venture capital investment fund. A closed-end or open-end investment fund whose primary investment objective is capital growth and whose capital is usually invested wholly or largely in restricted securities in negotiated transactions to form or develop companies with new ideas, products or processes.

voluntary accumulation plan. A plan offered by mutual fund companies whereby an investor agrees to invest a predetermined amount on a regular basis.

warrant. Certificates issued by a corporation that give the holder the right to buy its shares at a stated price over a specified period. The certificates are often issued in conjunction with a new issue of bonds, preferred shares or common shares.

when-issued. A short form for “when, as, and if issued.” The term indicates a conditional transaction in a security authorized for issuance but not yet actually issued. All such transactions are settled if and when the actual security is issued and the exchange determines that the transactions are to be settled.

wrap account. An account offered by investment dealers whereby investors are charged an annual management fee based on the value of invested assets.

yield curve. A graphic representation of the relationship among yields of similar bonds of differing maturities.

yield to maturity. The rate of return on a debt security held to maturity, giving effect to the stated interest rate, accrual of discount and amortization of premium.

yield. The return on investment that an investor receives from dividends or interest expressed as a percentage of the current market price of the security or, if the investor already owns the security, of the price paid. The return on shares is usually calculated by dividing the total dividends paid in the past calendar year by the price of the shares. The return on bonds is calculated by dividing the interest by the price of the bond.

zero coupon bond. A type of high-yield debt instrument that makes no periodic interest payment, but is issued at a discount from its face value. The holder derives a return from the gradual appreciation in the value of the security, which is redeemed at face value at a specified maturity date.
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