Chapter 3

Reasons: Decisions, Orders and Rulings

3.1 Reasons for Decision

3.1.1 AGF Funds Inc. et al.

IN THE MATTER OF
THE SECURITIES ACT,
R.S.O. 1990, C. S.5, AS AMENDED

AND

IN THE MATTERS OF
AGF FUNDS INC., AIC LIMITED, I.G.
INVESTMENT MANAGEMENT, LTD.,
AND CI MUTUAL FUNDS INC.

Hearing: Thursday, December 16, 2004

Ontario Securities Commission Panel:

Paul M. Moore, Q.C.	-	Vice-Chair (Chair of the Panel)
Susan Wolburgh Jenah	-	Vice-Chair
Robert W. Davis	-	Commissioner

Manitoba Securities Commission Panel:

Robert G. McEwen	-	Chair of the Manitoba panel
Kathleen E. Hughes	-	Commission member
John Bowman	-	Commission member

Counsel:

Jane Waechter Melissa MacKewn	-	For Staff of the Ontario Securities Commission
Benjamin Zarnett Jonathan Lampe	-	For CI Mutual Funds Inc.
James Douglas Lynn McGrade	-	For AIC Limited
Joel Wiesenfeld James Tory	-	For AGF Funds Inc.
Jeffrey W. Galway David Jackson David Valentine	-	For IG Investment Management Ltd.
Chris Besko	-	For Staff of the Manitoba Securities Commission

The following statement has been prepared for purposes of publication in the Ontario Securities Commission Bulletin and is based on the transcript of the hearing. The transcript has been edited, supplemented and approved by the chair of the panel for the purpose of providing a public record of the panel's decision in the matter.

ORAL REASONS FOR DECISION

VICE CHAIR MOORE:

1. DECISION

[1] This is a hearing under section 127 of the Securities Act for the Commission to consider whether it is in the public interest to make orders approving four settlement agreements entered into between staff and AGF Funds Inc. (AGF), staff and CI Mutual Funds Inc (CI), staff and IG Investment Management, Ltd (IG), and staff and AIC Limited (AIC).

[2] We have on the line by way of conference call the Manitoba Securities Commission represented by Bob McEwen, as Chair of the Manitoba panel, Kay Hughes, commission member and John Bowman, commission member.

[3] They will be participating in this settlement hearing with respect to IG. In Manitoba, the hearing is pursuant to Section 8(1) of the Manitoba Securities Act which has a similar text to what is being considered by the Ontario Commission: whether it's in the public interest to approve the settlement agreement.

[4] The Manitoba Securities Commission approves the settlement agreement with IG as being in the public interest. We approve the four settlement agreements as being in the public interest for the following reasons.

2. OVERVIEW

[5] It is the Commission's mandate to foster fair and efficient capital markets and confidence in those capital markets. The mutual fund industry is an important participant in Ontario's capital markets. As of June 30, 2004, AGF had $24 billion of mutual fund assets under management. The figures for AIC and IG for the same period were $12 billion, and $ 42 billion, respectively. As of November 30, 2004 CI had $35 billion under management.

[6] In order for there to be fairness and confidence in Ontario's capital markets it is critical that mutual fund managers faithfully and diligently fulfill their duty to fully protect the best interest of their funds (and the investors in those funds) such that certain investors are not given preferential treatment to the detriment of others. Ontario's investors must be in a position to believe that their investments will be treated with the utmost care by those in whose trust they are placed.

[7] The terms of settlement provided for in the settlement agreements are investor focused. By way of the settlement payments, investors who have been harmed as a result of the failure of the respondents to fully protect the best interest of the funds in which they invested, will be compensated.

[8] The making of settlement payments of the magnitude proposed (in addition to the respondents' agreement to take on the future costs of ultimate distribution to affected investors), is in keeping with the purposes of the Act and the principles by which those purposes are to be achieved. We are satisfied that the imposition of further or different relief in the circumstances would not better serve the purposes of the Act.

3. AGREED FACTS AND ADMISSION

[9] The agreed facts in support of the proposed settlement are set out Part IV of the settlement agreements.

Market Timing and the Harm Caused by Market Timing

[10] Market timing involves short-term trading of mutual fund securities to take advantage of short term discrepancies between the stale values of securities within a mutual fund's portfolio and the current market value of those securities.

[11] Stale values can occur in mutual fund portfolios comprised, in whole or in part, of non-North American foreign equities. Stale values of those securities may result in stale values of the units of a mutual fund as a result of the way in which the net asset value of most mutual funds is calculated for the purpose of determining the price at which an investor may purchase or redeem (buy or sell) a unit of the fund.

[12] A market timer will attempt to take advantage of the difference between the stale value and an expected price movement of a fund the following day by trading in anticipation of those price movements.

[13] Significant harm may be incurred by a fund in which frequent trading market timing occurs. Any such harm would be borne by all investors in the fund. In addition to dilution1, market timing in a fund also may result in certain inefficiencies in that fund. Those inefficiencies, which will vary depending upon the particular fund, may involve increased transaction costs and disruption of a fund's portfolio management strategy (including the maintenance of cash or cash equivalents and/or monetization of investments to meet redemption requirements) and may impair a fund's long-term performance.

Market Timing in the Respondent's Funds

[14] With respect to AGF, in the period August 2000 to June 2003, six institutional investors holding accounts in the AGF's funds (the Market Timing Traders) have been identified as having profited, in total, in those accounts, in the approximate amount of $47.9 million, in part as a result of their use of frequent trading market timing strategies. The figures for AIC were $127 million with respect to three Market Timing Traders for the period January 1999 to September 2003. The figures for IG were $36 million with respect to one Market Timing Trader for the period October 2000 to November 2002. The figures for CI were $90.2 million with respect to five Market Timing Traders for the period September 1998 to September 2003.

[15] The Market Timing Traders also achieved a return on their overall investment in the funds that was significantly higher than the return that long-term investors would have achieved during the same time period.

[16] The respondents entered into agreements with certain Market Timing Traders which reduced but did not negate the harm caused by frequent trading market timing. The agreements were not publicly disclosed. The respondents failed to recognize all of the costs (and, in particular, dilution) resulting from the frequent trading market timing strategies being used by the Market Timing Traders and did not implement appropriate measures to protect the funds from all of the associated harm.

Principle Based Regulation vs. Rule Based Regulation

[17] The four matters before us today are examples of principle based regulation, rather than rule based regulation.

[18] There are no rules against market timing.

[19] Indeed, when the rules for mutual funds were devised, I doubt whether the regulators were aware of the abuse entailed in market timing.

[20] But the principles governing the conduct of mutual fund managers are set out in section 116 of the Securities Act.

[21] In the four matters, there is no violation of specific rules. But there have been clear violations of the principles of fairness to clients going to the question of appropriate conduct for a mutual fund manager.

[22] We have a public interest jurisdiction to intervene in the marketplace and to blow the whistle when conduct goes off side basic principles.

[23] We are mandated by the Act to step in and take action in the public interest.

[24] Specific statements contained in the prospectuses and annual information forms (AIFs) filed by AGF for the years 2000 to 2003 (although not identical from year to year) disclosed that AGF could require the payment of a short-term trading fee of up to 2% in circumstances where an investor seeks to either switch between AGF Funds or redeem units of an AGF Fund within 90 days of having purchased the units. No such fees were ever imposed with respect to the activities of the Market Timing Traders. Specific statements contained in the prospectuses and AIFs filed by AIC for the years for the years 1999 to 2003 (although not identical from year to year) disclosed that AIC could require the payment of a short-term trading fee of up to 2% in circumstances where an investor seeks to either switch between AIC Funds or redeem units of an AIC Fund within 90 days of having purchased the units. Specific statement contained in the prospectuses and AIFs filed by IG for the years 2000 to 2002 (although not identical from year to year) disclosed that IG (directly, and through its affiliated distributor) could take certain steps, including imposing a fee of up to 3%, or prohibiting the purchase of further IG Funds, in circumstances where it was determined by the distributors that excessive switching by an investor between IG Funds would have a detrimental effect on the IG Funds. No such fees were ever imposed in respect of the Market Timing Trader. Specific statements contained in the prospectuses and AIFs filed by CI for the years 1999 to 2003 (although not identical from year to year) disclosed that CI could take certain steps, including the imposition of a fee of up to 2%, payable to the fund, in circumstances where frequent trading would have a detrimental effect on the fund's performance.

The Respondents' Duty to Act in the Best Interest of the Fund

[25] A mutual fund manager is required by Ontario securities law to exercise the powers and discharge the duties of its office honestly and in good faith and in the best interests of the mutual fund and, in connection therewith, to exercise the degree of care, diligence and skill that a reasonably prudent person would exercise in the circumstances. Compliance with this duty requires that a mutual fund manager have regard to the potential for harm to a fund from an investor seeking to employ a frequent trading market timing strategy and take reasonable steps to protect a mutual fund from such harm to the extent that a reasonably prudent person would have done in the circumstances.

Respondents' Admission

[26] Each of the respondents has admitted that its conduct in failing to protect fully the best interest of the funds in respect of the frequent trading market timing at issue in this proceeding was contrary to the public interest.

Steps to Eliminate Harmful Market Timing in Respondents Funds

[27] The settlement includes a representation by each of the respondents that it has adopted practices and procedures to prevent and detect frequent trading market timing that could reasonably be expected to be harmful to the respondents' mutual funds and unitholders of those funds. In addition, the settlement includes a representation by each of the respondents that its current monitoring of trades in its mutual funds indicates that these policies and procedures are working in that they have eliminated any potential adverse impact of frequent trading market timing.

4. THE PROPOSED SANCTIONS

[28] In this proceeding, staff and each of the respondents jointly request that the Commission make orders approving the settlement agreements which, by their terms, provide for the making of payments by the respondents for ultimate distribution to past and present unitholders of the respondents' mutual funds who were harmed by the frequent trading market timing at issue in this proceeding. The payments in respect of AGF will amount to $29.2 million, in the case of AIC will amount to $58.8 million, in the case of IG will amount to $19.2 million, and in the case of CI will amount to $49.3 million.

[29] The settlement payments represent a theoretical quantification of harm caused to the relevant funds and the unitholders of those funds that would have been prevented had the respondents fully protected the best interests of the relevant funds in respect of the frequent trading market timing activity at issue. The payments are also substantially greater than the profits that the respondents earned by way of management fees received in respect of the frequent trading market timing activity.

[30] In the cases before us the appropriate action is restitution to those who were harmed.

[31] The appropriate persons to make restitution are those companies who may not have profited to the same extent as those engaging in market timing but, nevertheless, on whose watch the harm was allowed to occur.

[32] Pursuant to Schedule "A" to the settlement agreements, the settlement payments are to be distributed in accordance with plans of distribution the terms of which will be subject to separate approval by staff and the Chair and a Vice-Chair of the Commission.

5. THE COMMISSION'S MANDATE

[33] The Commission's mandate in upholding the purposes of the Act is set out in s. 1.1 as follows:

(i) to provide protection to investors from unfair, improper or fraudulent practices; and

(ii) to foster fair and efficient capital markets and confidence in capital markets.

Securities Act, R.S.O. 1990, c.S.5, as amended, s 1.1.

[34] The primary means for fulfilling that mandate, as it relates to this case are the "requirements for the maintenance of high standards of fitness and business conduct to ensure honest and responsible conduct by market participants."

Securities Act, s. 2.1 (2) (iii)

[35] In addition, section 2.1 of the Act provides that the Commission shall have regard to the fundamental principle that, "effective and responsive securities regulation requires timely, open and efficient administration of this Act by the Commission."

Securities Act, s. 2.1 (3)

[36] The purpose of the Commission's public interest jurisdiction is neither remedial nor punitive; it is protective and preventive, intended to be exercised to prevent likely future harm to Ontario's capital markets.

Re Committee for Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission) (2001), 199 D.L.R. (4th) 577 (S.C.C.) at pages 590-91

6. GUIDELINES FOR IMPOSING SANCTIONS

[37] Appropriate sanctions should be determined by taking into account the specific circumstances of each case. The public interest is paramount:

> We have a duty to consider what is in the public interest. To do that, we have to take into account what sanctions are appropriate to protect the integrity of the marketplace.
>
> In doing this, we have to take into account circumstances that are appropriate to the particular respondents. This requires us to be satisfied that proposed sanctions are proportionately appropriate with respect to the circumstances facing the particular respondents.
>
> *Re M.C.J.C. Holdings and Michael Cowpland (2002), 25 O.S.C.B. 1133 at 1134*

[38] In determining the nature and duration of sanctions, the Commission may consider a number of factors including:

- the seriousness of the allegations;
- the respondent's experience in the marketplace;
- the level of a respondent's activity in the market place;
- whether or not there has been a recognition of the seriousness of the improprieties;
- whether or not the sanctions imposed may serve to deter not only those involved in the case being considered, but any like-minded people from engaging in similar abuses of the capital markets; and
- any mitigating factors.

> *Re Belteco Holdings Inc.* (1998), 21 O.S.C.B. 7743 at 7746
> *Re M.C.J.C. Holdings and Michael Cowpland*, *supra* at 1135

[39] Other factors the Commission may consider include:

- the size of any profit (or loss avoided) from the illegal conduct;
- the size of any financial sanction or voluntary payment when considered with other factors;
- the effect any sanction might have on the livelihood of the respondent;
- the restraint any sanction may have on the ability of the respondent to participate without check in the capital markets;
- the reputation and prestige of the respondent; and
- the shame or financial pain that any sanction would reasonably cause to the respondent and the remorse of the respondent.

> *Re M.C.J.C. Holdings and Michael Cowpland, supra at 1136*

[40] The Commission may also consider whether the respondent is a registrant.

> *Re Donnini* (2002), 25 O.S.C.B. 6225 at 6255, sanctions var'd [2003] O.J. No. 3541 (Ont. Div. Ct.), leave to appeal to the CA granted

[41] The Supreme Court of Canada in *Re Cartaway Resources Corp.* [2004] S.C.J. No. 22 at 15 and 16 has recently affirmed that the Commission may properly impose sanctions which are a general deterrent. Also in *Re Dornford* (2004), 21 O.S.C.B. 7499 at 7505 the Commission stated:

> In our view, taking into account general deterrence, in the case before us, would not be for the purpose of punishing Dornford, as argued by Mr. Douglas, but rather for a prophylactic purpose, the future protection of the marketplace not only from actions by Mr. Dornford but also from breaches of trust by others. Although *Mithras* speaks of deterring future improper conduct of a respondent, it does note that the Commission is

> "here to restrain, as best we can, future conduct that is likely to be prejudicial to the public interest in having capital markets that are both fair and efficient." It seems to us that *Warnes* does not in any way indicate that general deterrence can be taken into account for punitive purposes, but rather, in the securities law context, that it can be taken into account in determining what is necessary to restrain conduct by others that is likely to be prejudicial to the public interest in having capital markets that are fair and efficient.

[42] In addition to the foregoing factors the Commission has recently held that cooperation by a respondent which assists the Commission in meeting its objective of "timely and efficient administration and enforcement of the Act," is a significant mitigating factor to be taken account in assessing a proposed sanction.

> *Re Pollit (2004), 27 O.S.C.B. 9643 at para. 37*
> *Re Cassels* (2004), CarswellOnt 5006 at para. 32

[43] We also considered as precedents *Re Bonham* (2000), 23 O.S.C.B. 7767 and 7768 *Re King* (2001), 24 O.S.C.B. 1250 and 1273. These cases involved the failure of mutual fund managers to act in the best interest of their funds in the context of the valuation of funds.

[44] In reference to our mandate, and the guidelines and case law described above, we are guided by the following factors in determining the appropriate sanctions provided for in the settlement agreements before us:

a) The amount of the proposed settlement payments (together with the costs associated with distributing the funds to the affected investors) is significant and will undoubtedly act as specific deterrents with respect to frequent trading market timing activity. Given their magnitude, the settlement payments will also serve as a reminder for mutual fund managers of their obligation to protect the best interest of their funds through vigilant monitoring and supervision of the activities taking place within those funds;

b) Each of the respondents' reputation has been seriously affected as a result of this proceeding and the considerable amount of attention that the proceeding has been attracting in the media. Such reputational harm could be accompanied by additional financial consequences;

c) It is the Market Timing Traders who profited most significantly from the conduct at issue in this proceeding. The proposed settlement payments far exceeds the "profit" realized by the respondents as a consequence of their conduct;

d) Each of the respondents has cooperated fully with the Commission from outset of its investigation and as a consequence, has assisted the Commission in fulfilling its mandate of efficient and timely administration of the Act and proceedings brought thereunder;

e) It is a matter of public record that staff has made allegations concerning the failure of certain other mutual fund managers to implement measures to fully protect their funds from all of the harm caused by frequent trading market timing; and

f) Each of the respondents took steps to avoid some the harmful consequences of frequent trading market timing at the relevant time.

[45] In summary, the proposed terms of settlement are in the public interest because: (i) they are in keeping with the purposes of the Act and the principles through which those purposes are to be achieved; (ii) they will assist in restoring the confidence of investors in the mutual fund industry by directly compensating affected investors and providing significant public censure of the conduct at issue; and (iii) they will act as a general deterrent.

VICE-CHAIR WOLBURGH JENAH:

[46] I have a couple of observations to make. The settlement agreements which have been negotiated between Commission staff and the four respondents in these proceedings are, as we've heard, all investor focused. This would be, from our perspective, a compelling feature of any settlement agreement presented to the Commission for consideration and approval. It's particularly appropriate in these circumstances.

[47] The mutual fund industry is a vital and important component of our capital market, attracting a high level of retail investor participation in particular. It is for that reason, particularly fitting, that investors who have been harmed by the activity which is the subject of the agreed statement of facts which form the foundation of settlement agreements in these proceedings will be compensated by the respondents and that the respondents have agreed to bear the cost of developing and implementing the plan of distribution which will accomplish that objective.

[48] I would like to take the opportunity to commend staff of the Ontario Securities Commission for their excellent materials which anticipated and addressed the relevant issues in question which the panel might have in relation to the proposed settlement.

[49] I would also commend the respondents for their full cooperation with Commission staff in the investigation which has led up to these proceedings. This cooperation, as staff have noted in their materials, has enabled the Commission to fulfill its mandate to administer the Act in a fair and efficient manner and bring these proceedings to fruition in just over a year from when the staff's continuing investigation into the activities of late trading and market timing activity across 105 Canadian mutual fund companies was first launched.

[50] In these circumstances, approval of the settlement agreement is in the public interest.

MR. DAVIS:

[51] I have nothing to add.

VICE CHAIR MOORE:

[52] Manitoba Securities Commission, do you have any comments you would like to make?

MR. MCEWEN:

[53] No further comments, thank you.

Approved by the Chair of the panel
Paul Moore
December 16, 2004