COUNTRY REPORT CANADA 2008

Economic and Financial Background

As with most developed economies in the world, the most important development over the last 12 months affecting the Canadian economy has been the initial impact and fallout from the disruption of the sub-prime mortgage market and related securitized debt markets in the United States.

In Canada, the revelations in early 2007, regarding business practices in the U.S. sub-prime mortgage market largely went unnoticed until the disruption of the $35 billion non-bank asset-backed commercial paper (ABCP) market in August when issuers, unable to rollover their maturing paper, were denied funding by their liquidity providers. This led to a short-lived downturn in domestic equity markets in August as speculation surrounded the remaining Canadian financial firms regarding their level of exposure to the U.S. sub-prime mortgage market.

As this speculation subsided, the second impact to Canada of the credit crisis came through the currency channel in September through mid -November. As the Federal Reserve continued cutting interest rates to fight the credit crisis and it became evident that there would be a slowdown in the U.S. housing market if not a general slowdown in the U.S. economy, the currencies of major U.S. trading partners such as Canada began to rise against the U.S. dollar. Driven by the rising demand for oil and other natural resources and agricultural products from developing countries and developed countries other than the United States, the Canadian dollar hit an all-time high of $1.10 in early November. While this was a boon to the Canadian consumer shopping abroad, it led to an outcry from Canadian manufacturers – the bulk of which are located in the central provinces – who were now at a disadvantage in their target market – the U.S. economy. It also raised longer-term questions concerning the potential for 'Dutch disease'- the permanent squeezing out of domestic manufacturing due to international demand in the natural resources sector. At the same time inflation concerns in the Western, resource rich, provinces prevented the Bank of Canada from taking stronger measures regarding the appreciation of the Canadian dollar than if they were setting monetary policy for the central, export/manufacturing focused, provinces alone.

Concern over the rise of the Canadian dollar began to subside as the dollar fell below parity with the U.S. dollar in mid December and other issues concerning further exposure to the U.S. credit crisis hit Canadian equity markets. A second wave of write-downs by several large Canadian banks concerning the assets they held with exposure to the U.S. sub-prime mortgage market were made public in November and December. This resulted in another short-lived downturn in financial markets as it was still unclear whether or not the turmoil in the U.S. housing and financial markets would be long-lasting and whether or not it would spread to the real economy both within the United States and abroad to its large trading partners such as Canada – the U.S. consumer was still spending.

Further clarity in this regard came in early January as U.S. employment figures showed a substantial drop which led to revisions to forecasted demand for oil and other natural resources and a large sell-off of oil and other natural resource stocks in the Canadian equity market. On January 21, 2008 alone, the S&P/TSX Composite dropped by 4.75%. This marked the beginning of a third wave of pessimism in financial markets that ended with purchase, by JP Morgan Chase & Co., of Bear Stearns with the assistance of the Federal Reserve. During this period, there was another series of write-downs by Canadian financial institutions related to assets tied to the U.S. sub-prime mortgage market.

After the purchase of Bear Stearns in mid March, equity markets in Canada rebounded as the demand for oil and other commodities worldwide continued to rise in response to future supply concerns, the subsidization of domestic demand in some developing countries, and the increase in the use of oil and other commodities as a hedge against the U.S. dollar.

Despite rebounding domestic equity markets, the still relatively high Canadian dollar and the progression of the U.S. credit market and housing market disruptions to the real economy in the U.S. in turn affected the real economy in Canada as well. Canadian real GDP fell 0.2% in the first quarter of 2008 due to slowing exports. Real GDP was up only slightly (0.1%) in the second quarter due mostly to rising inventories and moderating personal spending.

Looking back on the past year, the effects of the U.S. credit crisis have been felt mostly in financial markets rather than the real economy though there were some, still relatively minor, reverberations felt there in the first half of 2008. Canadian financial institutions have been relatively unscathed compared to their peers in the U.S. and in other developed economies. This was largely due to their minor exposure – in the aggregate - to financial assets backed by sub-prime mortgages. Furthermore, given the relatively conservative lending practices by Canadian financial institutions in the domestic housing market, it is unlikely that Canadian housing prices will see the declines witnessed thus far in the U.S. housing market though the market may continue to soften particularly in the Western provinces that have seen the highest gains and most aggressive lending practices in recent years.

Going forward, though there may be more reverberations to be felt from a larger slowdown of the U.S. economy and, potentially, the global economy, the fundamentals, with respect to levels of government debt, inflation and unemployment put Canada in a strong position from which to face any future economic obstacles.

Statistical Update and Commentary on Canadian Fund Activity

Complete statistical updates and commentary are provided by IFIC monthly at www.ific.ca. A comprehensive year-in-review is also published for the previous calendar year at the end of January.

Industry Update and Trends

Events stemming from the disruption in U.S. credit and housing market over the past year have had their corollary in mutual fund buying and selling behaviour in Canada. The disruption to the Canadian non-bank asset-backed commercial paper market in August 2007 led to a sell-off of Money Market funds (-$990 million) holding these securities and a sell-off of long-term funds in general (-$559 million).

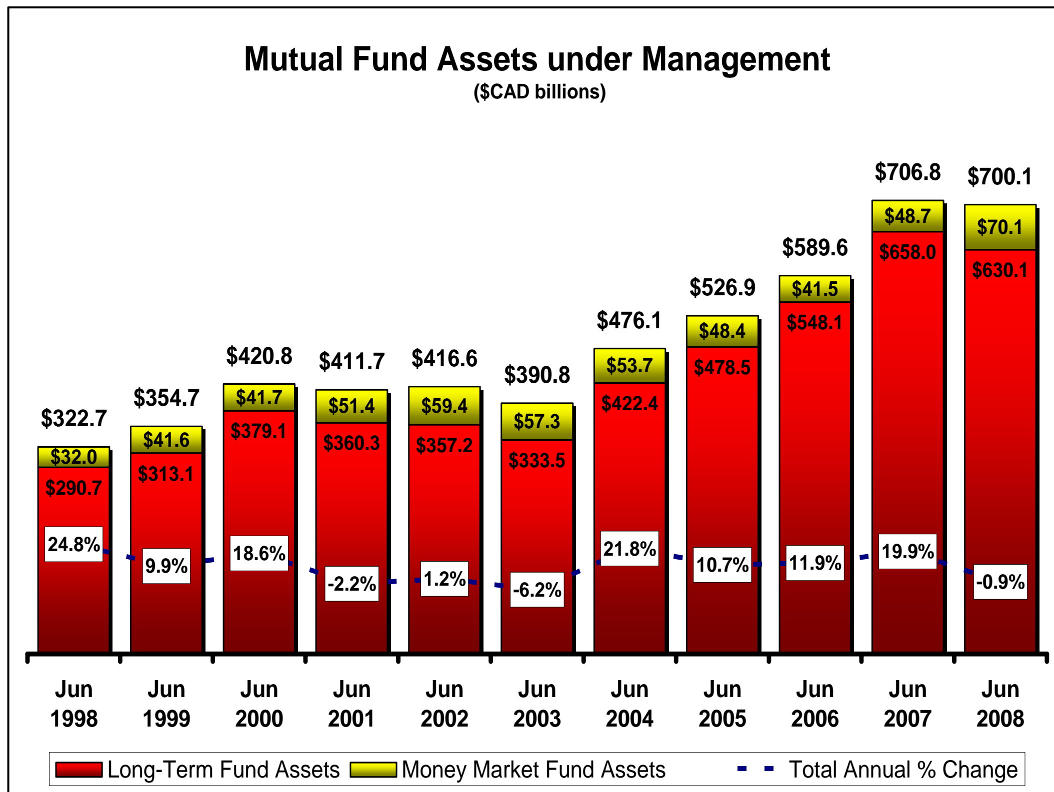
Canadian Mutual Fund Industry ($CAD Millions)

As
with

Asset Class	Assets		Net Sales (excl. dist) for the 12 months ending	
	June 2008	June 2007	June 2008	June 2007
Equity Funds	**312,939**	**347,823**	**-6,032**	**4,335**
Domestic Equity	177,883	188,390	-5,356	-8,454
Global and International Equity	94,677	115,231	-724	12,546
U.S. Equity	21,797	26,672	-506	363
Sector Equity	18,582	17,531	554	-120
Balanced Funds	**252,242**	**248,958**	**10,053**	**24,959**
Domestic Balanced	152,953	153,175	2,474	7,724
Global Balanced	99,289	95,782	7,579	17,235
Bond Funds	**58,904**	**56,753**	**-1,429**	**512**
Domestic Fixed Income	51,302	48,632	-1,021	85
Global and High Yield Fixed Income	7,602	8,121	-408	426
Specialty Funds	**5,967**	**4,547**	**1,283**	**967**
Long-Term Funds Total	***630,052***	***658,080***	***3,875***	***30,773***
Money Market Funds	**70,074**	**48,681**	**19,266**	**4,371**
All Funds	***700,126***	***706,761***	***23,141***	***35,144***

financial markets over the period, this sell-off was short-lived as October and November saw a return to positive net sales territory ($2.4 billion and $1.8 billion respectively). Sales over this period were buoyed by the rise in the Canadian/U.S. exchange rate which led to an increase in the demand for U.S. Money Market funds by investors looking to buy the U.S. dollar on the cheap. In addition, volatility in equity markets worldwide in the fourth quarter of 2007 led to a drastic increase in the demand for Money Market funds in general. Money Market funds sales for the fourth quarter totaled $5.6 billion – the highest quarterly inflow for the asset class since the fourth quarter of 2001.

Increased equity market volatility including the 605 point drop in the TSX/S&P Composite on January 21, 2008 and a realization that events south of the border were likely to be longer lasting than first thought, led to a massive rebalancing of Canadian investor portfolios including a record amount of net redemptions (-$4.3 billion) in long-term funds and net sales ($4.8 billion) in Money Market funds.
Since the rebalancing in January, Canadian mutual fund investors have remained focused primarily on Money Market funds preferring to take a 'wait and see' approach with regard to equity markets both at home and abroad.



Data for the last 12 months ending June bear this out. Asset growth over the past year has been strongest for Money Market funds, growing $21.3 billion due mostly to the $19.3 billion in net sales over the period.

This is in sharp contrast to what has occurred in the Equity space over the last 12 months. Equity mutual fund assets fell from $347.8 billion to $312.9 billion at the end of June 2008, as the effects of market volatility and $6 billion in net redemptions took their toll.

In the Balanced fund space, assets grew slightly from $249 billion to $252.2 billion as fund sales ($10.1 billion over the period) particularly, sales to fund-of-fund products, remained strong.

There was growth in Bond fund assets ($2.1 billion) as well over the last 12 months, largely due to performance in the domestic fixed income market. This also was in spite of $1.4 billion in net redemptions over the period.

As we look forward to the coming year, we expect that though investors are currently waiting on the sidelines, they will begin to move back into long-term fund products once they feel that the worst is past. We see it as a positive sign that though total net sales were down over the last 12 months and primarily focused on Money Market funds, investors are still contributing to their wealth despite recent events.

Regulatory and Self-Regulatory Developments

Point of Sale Disclosure

A proposed framework for Point-of-Sale (POS) disclosure for mutual funds and life insurance-regulated segregated funds was initially released in June 2007 by the Joint Forum of Financial Market Regulators (Joint Forum), a voluntary association of securities, insurance and pension regulators, and described the elements of a new disclosure system. The framework included a new two-page fund summary document called Fund Facts and outlined its delivery options, investor rights and the regulatory requirements for preparing, filing and delivering the document. The

Canadian mutual fund industry responded positively to the idea of more precise and more meaningful information via the Fund Facts, but found some of the requirements for delivery disruptive to the advisor-investor relationship.

In June 2008, a Working Group of the Joint Forum made recommendations to take to the whole Joint Forum in the fall. They include having two types of transactions – either investor-initiated or advisor-initiated – on an investor's first purchase of a mutual fund. Under the recommendations, there would be no requirement for investors to receive a Fund Facts through a sale they initiate – whether it be through a discount brokerage or a full-service advisor. Investors would have the option to receive the Fund Facts on all their funds on an annual basis however. The new recommendations included that investors could waive the Fund Facts document when purchasing money market mutual funds, and if a waiver was given, the Fund Facts would go out at confirmation.

In addition, the Working Group recommended that there be a two-day cooling off period with the timeframe beginning on receipt of the trade confirmation rather than at the time the instruction was given to purchase. The Joint Forum withdrew its original proposal for a perpetual right of rescission if no Fund Facts were delivered.

The next step, after approval of the framework by the Joint Forum, will be implementation through the separate rule-making processes of the regulators of the mutual fund and segregated fund industries.

Registration Requirements

Proposed National Instrument 31-103 is a major regulatory initiative intended to streamline registration requirements applied by Canada's 13 different jurisdictions and to change the basis of regulation to a business trigger from the current trade trigger.

In its second version of NI 31-103, the Canadian Securities Administrators (CSA), a forum for the 13 securities regulators to coordinate and harmonize regulation, made significant improvements to the proposals, but several areas of concern still remain.

The main issue is the proposal to set up a registration system for exempt market dealers (EMD) in an attempt to ensure that more securities dealers are registered. The proposed regulation would not require EMDs to be members of an SRO and therefore not subject to SRO oversight regulations and investor protections. The EMD category would replace the Limited Market Dealer (LMD) category that currently exists in two provinces, including Ontario. However, the LMD is used primarily for underwriting and selling prospectus-exempt products, not widely used as a distribution channel for mutual funds. The industry is concerned that the creation of the EMD would legitimize these firms as distributors of mutual funds in the eyes of both mutual fund companies and investors, resulting in an erosion of the SRO framework and the investor protections it provides.

IFIC made recommendations to regulators that EMDs should be regulated by the Investment Industry Regulatory Organization of Canada (IIROC) – formerly the Investment Dealers Association of Canada – or the Mutual Fund Dealers Association of Canada (MFDA) as appropriate. The exception would be for the handful of EMDs that currently distribute conventional mutual funds which, IFIC proposed, should be grandfathered from this SRO membership proposal so there would be no effect on their business models.

Another area of concern is the lack of harmonization on a number of regulatory fronts, including complaint handling, relationship disclosure requirements and the lack of co-ordination of necessary legislative amendments across provinces required to implement the registration requirements.

Client Relationship Model (CRM)

The core principles of the CRM deal with clarity and transparency of the account relationship entered into among the client, the advisor and the dealer, including the disclosure of client costs, advisor conflicts and account performance and risk.

Two SROs are dealing with the issue separately. IIROC was first to publish its rule in February 2008, while the MFDA released its rule amendments in June. Both contained requirements for clarifying the relationship between the client and the advisor, clarifications regarding triggers for

reviewing suitability and new requirements for providing clients with a minimum level of information about the performance of their investments.

IFIC urged both SROs to adopt flexible rules for performance reporting to foster effective solutions tailored to the client, rather than prescribed solutions that may or may not be informative and may confuse or misinform the client.

IFIC also asked that regulatory policies in this area be harmonized to ensure that the client experience is common and consistent across all products and providers. In particular, IFIC called on the SROs to align their policies and rules with those of other regulators to avoid duplication and overlap.

Complaint Handling

The MFDA and IIROC also released separate amendments to their rules aimed at enhancing the timeliness of responses from companies and when firms should provide information to clients on the dispute resolution process.

In its submissions, IFIC noted the mutual fund industry is subject to oversight from numerous regulatory bodies and agencies across Canada – not only IIROC and the MFDA, but also the separate securities commissions and the Ombudsman for Banking Services and Investments (OBSI) Each has its own complaint-handling policies and procedures and they differ in many respects.

Some of these proposals would add further inconsistency and confusion for investors, IFIC noted in its submissions. As well, IFIC pointed out that a "siloed" approach to rulemaking in the various agencies involved with complaint handling can lead to different responses and may require the development of multiple systems within firms, depending on their business models and the jurisdictions they operate in.

IFIC urged alignment among the various organizations involved in the policy setting and oversight of complaint handling to achieve a harmonized and consistent approach for the benefit of market participants and investors.

Passport/national regulator

The issue of a single national regulator versus a "passport" style of regulation has been bubbling for a number of years. The Ontario and federal governments support a single securities regulator. Most of the other provinces are in favour of the passport system, which grants a market participant access to capital markets in multiple jurisdictions by dealing only with its principal regulator and complying with one set of harmonized laws. Ontario decided to opt out of the passport system, necessitating the creation of an interface between the passport jurisdictions and Ontario that favours market participants in the latter. IFIC has advocated for a level playing field for all market participants.

In February 2008, the federal government appointed the Expert Panel on Securities Regulation charged with – among other issues – proposing legislation for a single Canadian securities regulator. IFIC outlined its position: that it is essential that the mutual fund industry have a harmonized, consistent system to enhance the investor experience and make everyday business decisions equitable regardless of the home jurisdiction. This outcome can be achieved through a variety of models. The CSA has already achieved a high degree of harmonization and any new regulatory framework must remain at least as effective and efficient.

In March 2008, two new policies came into force in all provinces and territories. They set out the processes for the filing and review of prospectuses and exemptive relief applications, replacing the current mutual reliance review systems for those two issues with a modified passport model where participants need interact with, at most, their home regulator and Ontario. In July 2008, the CSA issued the proposed passport for registration; comments are due by mid-September 2008.

In other regulatory news…

Quebec's financial regulator, l'Autorité des marchés financiers (AMF), decided in September 2007 to directly maintain its regulatory oversight of the Quebec mutual fund industry. To improve harmonization across the country, the AMF will adopt MFDA-like rules by the end of 2011.

In June 2008, the national SRO that oversees investment dealers and trading activity in debt and equity marketplaces became officially known as the Investment Industry Regulatory Organization of Canada (IIROC). IIROC was created following the merger of the Investment Dealers Association of Canada (IDA) and Market Regulation Services (RS). Previously the IDA had been responsible for the regulation of investment dealers and RS had been responsible for the regulation of trading activity.

Taxation

The framework for IFIC's tax policy initiatives over the past several years has been "helping Canadians save for their own retirement," and in 2007-2008, a number of successes could be counted based on this theme.

In the spring of 2008, after a number of years of lobbying by various industry groups, the federal government announced the creation of the Tax Free Savings Account (TFSA) – one of the most significant new savings vehicles in Canada in many years. This new savings idea will provide Canadians with more flexibility in planning their optimal savings strategies. With a TFSA, an individual can invest $5,000 of after-tax income per year and the investment income earned will be free from tax. In addition, over the long-term, this additional savings vehicle should help foster the growth in savings among Canadians.

Another major win in the last year was the passage of a federal law that provides bankruptcy protection for two of the largest tax-deferred savings vehicles: Registered Retirement Savings Plans and Registered Retirement Income Funds. The new bill puts these two savings plans on a more equal footing with other major retirement vehicles such as pensions.

Accounting Standards

Full adoption of International Financial Reporting Standards (IFRS) takes place in Canada in 2011, and IFIC's Accounting Advisory Working Group has found a number of cases in which the new standards are not appropriate for investment funds and would instead provide misleading and confusing information to users of fund financial statements. Accordingly, IFIC has been working with Canada's securities regulators to amend parts of a National Instrument on continuous disclosure to ensure financial statement reporting and disclosure in Canada remains meaningful.

In addition, the Working Group, in concert with other mutual fund organizations throughout the world, made submissions to the International Accounting Standards Board suggesting changes to IFRS that would provide investors with more meaningful financial information of their investment funds. The two primary areas of concern were the IFRS requirement to use bid prices to value actively traded investments and the requirement under IFRS to split investor equity. The Working Group told the IASB that neither of these requirements would be useful for users of mutual fund financial statements. The IASB has said it will take IFIC's comments into consideration.

Fund Governance Developments

Since coming into force in November 2006, National Instrument 81-107 (*Independent Review Committee for Investment Funds)* has required fund managers to appoint an Independent Review Committee (IRC) to oversee all matters involving actual and perceived conflicts between the interests of the person or company that directs the business, operations and affairs of a fund and those of the fund.

An IFIC Working Group has developed guidance relating to various aspects of the rule's implementation, including an IRC Charter Framework and pre-implementation and post-implementation checklists to assist IFIC members on how to handle issues that may arise in the future. It also provided fund managers and their IRCs with information and resources to assist with IRC self-assessments required by the rule. While the effectiveness assessment requirements are obligations of the IRC rather than the fund manager, in many cases IRC members will look to the fund manager for guidance and assistance in carrying out these reviews and implementing any changes.

Product Developments

Two new product developments over the past year include the growth in popularity of tax-efficient (often called T-series) versions of existing mutual funds and the introduction of Retirement Payout/Income Replacement funds. Both products respond to the needs of an aging populace that is drawing closer to retirement – a development that is affecting most OECD countries.

The number of tax-efficient mutual fund series has been on the rise over the past several years. These series are different from more traditional unit/share series in that there is a focus on paying out consistent absolute or percentage monthly distribution and a focus on paying out a consistent portion of this distribution in the form of return of capital along with regular capital gains, dividend and interest income in order to reduce the investor's annual tax burden. While these series have been available for a few years now, their popularity with investors has skyrocketed over the past year. Estimates put the total assets in these series at $8.2 billion at the end of 2007, up 228% from the previous year.

The second development over the past year has been the introduction of Retirement Payout/Income Replacement funds. These products are different from traditional target-date funds in that they are designed, in terms of portfolio holdings etc., to start-off where target-date funds end – at the date of retirement. Essentially, they are designed to be a continuation of the target-date product, the investments become more conservative as the target-date is reached but also there is an emphasis on maintaining a steady stream of income or payout of the portfolio till it is depleted – either in full or in a pre-determined part - at the new target-date. While Retirement Payout/Income Replacement funds have many uses they are primarily aimed at retirees.