Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels

Contact: Paige Ward
Director, Policy and Regulatory Affairs
Phone: 416-943-5838
E-mail: pward@mfda.ca

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MFDA Bulletin

Policy

For Distribution to Relevant Parties within your Firm

Regulatory Gap in Canada – Fund Managers: The Need for a Compensation Fund

The MFDA is issuing a report regarding the need for a compensation fund for investment fund managers and portfolio managers. The report is being issued in light of recent developments including comments received during consultations with Members in regard to changes to the MFDA IPC and requests from Members and other stakeholders. While the report was prepared back in November 2008, the MFDA believes that the key issue identified and discussed, the need to ensure proper protection of Canadian investors by extension of compensation fund coverage to clients of portfolio managers and investors who hold their investments funds in client name at fund managers, remains relevant and current today.

The report entitled "*Regulatory Gap in Canada – Fund Managers: The Need for a Compensation Fund*" is attached to this bulletin.

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November 20, 2008

Jean St. Gelais
President and Chief Executive Officer
Autorite des marches financiers
800, Square Victoria 22e etage
Montreal, Quebec H4Z 1G3

Dear Mr. St. Gelais:

In your letter of May 7, 2007 in response to our report entitled *'Regulatory Gap in Canada: Fund Managers – The Need for Active Regulation and a Compensation Fund'*, the CSA requested additional information with respect to the investor compensation fund issue. In this regard, we are enclosing MFDA Staff's follow-up report on the compensation fund recommendation for fund managers.

We recognize that if the CSA mandated a compensation fund for fund managers, many complex issues, including coverage policies and assessment methodologies, would need to be worked out and in this regard extensive consultation with relevant stakeholders would be necessitated.

Once you have had an opportunity to review the report, we would be pleased to discuss it with you at your convenience.

Yours truly,

Larry M. Waite

cc. CSA Chairs
MFDA Board of Directors
Mark Gordon, MFDA
Doug MacKay, CSA MFDA Oversight Committee

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Regulatory Gap in Canada - Part II

Fund Managers: The Need for a Compensation Fund

November 20, 2008

Executive Summary

Investor compensation fund participation should be required for investment fund managers and portfolio managers. The amounts at risk are significant: more than $225 billion in mutual fund assets purchased by clients of MFDA Members are held at the investment funds and are not subject to IPC coverage; and the total amount of assets at risk is significantly higher when taking into account the assets under administration of all fund managers and portfolio managers. Market confidence and efficiency, fairness and, above all, suitable investor protection demands compensation fund coverage apply more broadly.

Introduction

In 2007, the MFDA provided the CSA Chairs with a paper entitled Regulatory Gap in Canada: Fund Managers – the Need for Active Regulation and a Compensation Fund (the "Regulatory Gap Report"). The Regulatory Gap Report outlined the MFDA's concerns and made recommendations on what might be done to address these issues.

The challenges faced by the MFDA are connected to substantive gaps that are present in the regulation of investment fund managers[1] and portfolio managers, because the business of mutual fund dealers and the protection of their clients is closely related to and affected by the activities of these other market participants. This is the result of extensive linkages – operational, sales channels, marketing and ownership – among the firms. In particular, a high proportion of client assets at MFDA Members are held in client name on the books of the investment funds and the fund managers have a key role in both the flow of client assets to and from the funds and keeping records for the funds and investors (such as trade confirmations and client statements). Weaknesses in the regulation of any of the participants in the investment chain lessen the effectiveness of the regulation of the market and thus the protection afforded investors.

Proposed National Instrument 31-103 Registration Requirements ("NI 31-103") addresses some of the gaps in regulation of fund managers identified in the Regulatory Gap Report. But even with full implementation of the instrument, the regulatory structure applicable to fund managers and portfolio managers will not be as comprehensive or effective as prudent regulation demands and Canadian investors deserve. The regulatory regime contemplated by NI 31-103 contains none of the key investor protection mechanisms of self-regulation: no investor compensation fund, no specific internal controls or risk management rules that safeguard investors' assets, and no early warning capital requirements or monthly financial reporting that may identify trends of concern.

The purpose of this report is to respond to the request from the CSA to supplement the discussion in the Regulatory Gap Report regarding the issues relating to compensation fund coverage for market participants other than members of the MFDA and Investment Industry Regulatory Organization of Canada ("IIROC"). In our view, proper protection of Canadian investors requires extension of compensation fund coverage to: (a) clients of portfolio

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[1] NI 31-103 does not contain a specific definition of investment fund manager. "Fund manager", as used in this paper, expands upon the definition of 'manager' set out in NI 81-102 ("a person or company that directs the business, operations and affairs of a mutual fund") to encompass a manager of any investment fund. The fund manager generally organizes the fund and contractually accepts responsibility for its management and administration under a management agreement with the fund's trustees or directors. In some cases, the fund manager also provides portfolio management services to the fund; that is, it makes the investment decisions for the fund. The fund manager usually has the authority to sub-delegate any of its responsibilities to other service providers.

managers; and (b) investors who hold their investment fund securities in client name at fund managers.

Purpose of Compensation Fund Coverage

Among other objectives, securities regulation seeks to protect investors and the marketplace by reducing the risk of failure of intermediaries. This is accomplished through the imposition of:

- Proficiency requirements and registration checks to weed out the incompetent or unethical;
- Minimum capital standards to provide a buffer against adverse business conditions;
- Risk management and internal control requirements to promote prudent practices and reduce the risk of defalcation; and
- Fidelity insurance coverage.

If, despite this first layer of protections, something goes wrong and failure occurs, other securities regulatory mechanisms are designed to reduce the exposure of clients to losses caused by that failure. These mechanisms include requirements to segregate client assets and hold client cash in trust accounts to prevent seizure by other creditors of the failed intermediary. Prompt intervention by securities regulatory and compensation fund authorities also helps to minimize losses and disruptions.

Effective oversight by regulators through active on-site and off-site supervision promotes regulatory requirements being met in practice. However, securities regulation, no matter how pervasive, cannot prevent market intermediaries from failing or totally eliminate the risk of losses to clients when this happens. There will always be a significant risk that the rules designed to protect client assets will prove to have been broken – a fact that will only become evident after the firm has failed.

Compensation fund coverage is intended to fill the gap in investor protection that other securities regulatory requirements cannot eliminate. The primary purpose of compensation fund coverage is to maintain investor confidence in the marketplace by compensating clients of failed intermediaries for losses caused by those failures. It is, in effect, the final layer in the investor protection regime. In addition, compensation funds serve a very practical purpose. The compensation fund operators usually have the expertise and resources to intervene early in the insolvency process, appoint a receiver and take other actions to minimize disruption to the markets and inconvenience to clients.

Current Compensation Fund Coverage in Canada and Investor Protection Gaps

Clients of investment dealers in Canada are covered by the Canadian Investor Protection Fund (“CIPF”). The MFDA Investor Protection Corporation (“IPC”) covers losses suffered by clients (outside Quebec) of an MFDA member. Securities and certain other assets received, acquired or held by the investment dealer or mutual fund dealer in a client account at the dealer are covered for losses up to $1 million per client. All mutual fund dealers operating in Quebec must contribute to the Fonds d'indemnisation des services financiers ("FISF") administered by the Autorité des marchés financiers (“AMF”). Victims of fraud, fraudulent tactics or embezzlement for which a firm is responsible can be compensated for up to $200,000 per claim.

The operations of CIPF and IPC provide substantial protection for investors from losses on the failure of member dealers. However, the protection afforded these investors is not complete. As

noted, both CIPF and IPC only provide coverage to the assets received, acquired or held in a client's account at a member dealer. Client assets that are not held by the dealer or recorded in a client's account as being held by the dealer would not generally be covered by either IPC or CIPF. For clients of investment dealers, the remaining gap in coverage is small, as investment dealers hold most client assets in the dealer's name. The gap is much larger for mutual fund dealers, as more than 80%[2] of clients' mutual fund assets are held in client name at the investment funds. Securities positions held directly at these investment funds and client money handled by investment fund managers are not covered by a compensation fund, despite the fact that losses through fraud or insolvency are reasonably foreseeable.

Portfolio Managers. Portfolio managers make investment decisions for substantial assets that belong to their clients. The Investment Counsel Association of Canada estimates that its members have over $700 billion[3] of assets under management[4]. Many portfolio managers hold client assets at third party custodians. Where the custodian is at arm's length to the portfolio manager, client assets should be unaffected by the insolvency of the portfolio manager. However, in certain circumstances portfolio managers are permitted to hold client assets directly. Further, even where the portfolio manager does not hold client assets directly, virtually all portfolio managers have broad discretionary control over the client assets in their accounts. Diverting these assets deliberately or through inadvertence would not be difficult. It is also noted that the regulatory requirements imposed on portfolio managers are not extensive and the level of active oversight by securities commissions is substantially less than that applied to IIROC and MFDA member firms.

Fund Managers. These firms often perform key administrative, operational and marketing functions for the funds that they manage. The fund manager is the conduit through which client purchase and redemption orders funnel. Many act as the principal record keeper for their funds, including maintaining securityholder registers and purchase and redemption transaction records, and sending out trade confirmations, periodic client statements and tax data to their funds' investors. These key functions may all take place in the same firm, thereby giving an unethical or incompetent manager wide latitude to 'manage' the books of the funds. The fund manager may also act as portfolio manager or principal distributor for its funds, giving the manager even greater access to client assets. The value of assets in investment funds is substantial. As of the end of 2007, members of the Investment Funds Institute of Canada had slightly less than $700 billion of assets under management in investment funds.

The only fund managers presently subject to specific regulatory requirements are those who act for mutual funds subject to NI 81-102. Many of those requirements are only indirectly applied to fund managers and do not address fully the risks to investors if the fund manager becomes insolvent. Fund managers that are also principal distributors are required to hold client money in trust accounts. Securities owned by the funds are required to be held by a qualified custodian, although there is no requirement that this custodian be at arm's length to the fund manager.[5] Also, a custodian can only protect assets that are delivered to the custodian.

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2 No one has sufficient information to make a precise calculation of this figure. The MFDA estimated that approximately 84% of mutual fund assets are recorded in client name. This estimate does not include mutual fund assets for clients of MFDA Members located in Quebec.

3 http://www.investmentcounsel.org/aboutus.asp?id=13

4 This number underestimates the aggregate value of assets under management by portfolio managers, as not all firms are members of the organization.

5 The custodial provisions in NI 41-101 mirror those in NI 81-102.

NI 81-102 imposes general record keeping and securityholder register requirements. Custodial and trust account arrangements must be verified by audit confirmation, but no similar audit confirmation applies directly to the general record keeping or securityholder register requirements. NI 81-102 fund managers are not subject to minimum capital or financial reporting requirements. There is little, if any, direct oversight by regulators and no minimum internal controls or risk management standards apply.

A fund manager of other types of investment funds is subject only to whatever duties the common law, the declaration of trust creating the fund, or the contract with the fund imposes on the relationship.

Further, there are no restrictions on what other business activities any type of fund manager may carry on, so the risk profile of firms may vary widely.

The *Proposal on Registration Reform*, published in January 2006 in connection with the CSA Registration Reform Project observed that the risks presented by investment fund managers were incompletely addressed by the existing requirements. NI 31-103, if implemented as proposed, would introduce specific standards for all fund managers in the areas, inter alia, of capital, insurance, record keeping and segregation of client assets. However, while these requirements address some of the investor protection and solvency risk issues of concern, there remain significant gaps.

The solvency risk for fund managers is as least as high as for many other financial services businesses. They are not exempt from operational risks[6] that include incompetence, fraud or other general business risks. The role the fund manager plays in the fund complex makes the level of operational risks faced by the fund manager of particular concern.

Why There Should Be Coverage

Canadian investors exposed to similar risks should be entitled to similar protection. Clients of mutual fund dealers and investment dealers should not be the only clients covered by a compensation fund in the event an intermediary fails and its clients suffer losses. The coverage of even these clients should not be at the mercy of how their assets were recorded on the books of the dealer, a matter over which they have no control. In particular, both portfolio managers and fund managers should be required to participate in a compensation fund offering similar coverage to that of CIPF or IPC. Arguments against compensation fund participation based on (i) there being no risk, (ii) there having been no failures; or (iii) the costs imposed outweighing the benefits created; do not stand up on examination, as set out below. Further, fairness and the maintenance of market confidence support the participation of these managers in a proper compensation regime.

Access equals Risk. Where there is access to client assets, there are risks to clients that can be alleviated only by compensation fund coverage. Any participant in the investment process chain that has any access in practice to client assets may pose a risk to clients. The potential exposure may not be affected by what the rules say is supposed to happen at the firm. The third highest loss experienced to date by CIPF was the failure of IDA member, Essex Capital Management Inc., an introducing broker that was not supposed to have any client assets on its books. The Essex case illustrates that there can be a substantial risk of loss to clients on the

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[6] Operational risk means the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. It would encompass risks of losses through systems errors, accounting mistakes, fraud or negligence, etc.

failure of an intermediary even where that intermediary is not supposed to be holding client assets.

SRO member dealers are subject to the highest standards and the most active level of regulation and oversight compared to other market participants. This should result in solvency or compliance problems being identified and addressed earlier. Nevertheless, as Essex demonstrates, insolvencies and consequential investor losses can still occur when rules are violated. Not requiring compensation fund coverage for other market participants might make sense if they pose negligible risk of loss to their clients on failure. However, since compensation fund coverage protects investors from losses where other regulatory measures have failed, it is both reasonable and logical to look beyond what the rules say should be taking place when assessing the risks.

The access to client assets is significant for a portfolio manager with discretionary authority, whether or not it holds client assets on its books or otherwise acts as trustee of its clients' assets. A fund manager that is involved in every purchase or redemption transaction, plus acts as registrar, bookkeeper and issues most trade confirmations and client statements for its funds also has access. These firms may not be 'holding client assets' in the same way as would an investment dealer or Level 4 mutual fund dealer, but investors are still at risk if the manager fails and there proves to be problems with the accounts.

Europe and UK. The European Union Investment Compensation Scheme Directive[7] recognizes that clients face a risk of loss when dealing with portfolio or other asset managers. All investment firms, which term includes portfolio managers, are required to participate in an investor compensation scheme. Participation is mandatory despite the fact that in many European countries all client securities and cash under the administration of an asset manager are required to be held at a third party custodian that is a regulated financial institution. The UK compensation fund takes this logic one step further and requires any entity that establishes an investment fund or safeguards or administers investments – which would include both fund managers and custodians – to participate in the compensation scheme.

Canadian Experience. One cannot simply argue that since there have been no significant failures of either portfolio managers or fund managers leading to client losses, therefore these firms do not need to be covered by a compensation fund. Both CSA precedent and recent manager failures undercut this position.

First, there have recently been three very large failures of registrants involving portfolio managers that were also fund managers (Norshield Asset Management (Canada) Ltd., Portus Alternative Asset Management Inc. and Norbourg Asset Management Inc.).

Second, the CSA thought it was sufficiently important that clients of mutual fund dealers be covered by a compensation fund that it required the MFDA to establish one as a condition of its recognition as an SRO. This requirement cannot have been triggered by experience with mutual fund dealer failures causing losses to Canadian investors, as there had not been any such failures, and thus no consequential investor losses, at the time the MFDA was recognized.

While the particular reasons for the CSA requiring mutual fund dealers to participate in a compensation fund were not readily transparent, it is understood that prudent investor protection was the objective and that the significant growth in investor participation in this segment of the market through mutual fund dealers may have been a factor in the decision. If growth in assets, whether or not coupled with insolvencies leading to client losses, justifies the imposition of compensation fund participation, then both the portfolio management and fund management

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[7] European Union Directive 97/9/EC

communities clearly should be caught. The growth in assets under management at mutual fund dealers has been mirrored by substantial growth in assets under management at portfolio managers and the mutual funds themselves.[8]

Cost/Benefit. Some argue against requiring compensation fund participation for portfolio managers and fund managers on the assumption that the benefit to investors would be outweighed by the costs of participation that would be imposed on these intermediaries. The cost assumptions may, in part, flow from expectations of significant fixed costs of establishing a fund and the relatively small size and number of the intermediaries to be covered. This suggests building a fund of sufficient size to generate meaningful coverage amounts per client would require imposing prohibitive fees on the participants. However, this argument does not take into account the substantial size of the assets under management at the managers and the fact that costs can be minimized by including new categories of members in one of the existing compensation funds.

It is true that operating a compensation fund will entail certain fixed costs for administration but the size of those costs depends on the structure chosen. In Canada, none of the CIPF, IPC or FISF has a large infrastructure in place. Establishing a whole new fund for portfolio managers and fund managers is probably not necessary or advisable and the marginal cost of including these firms in either CIPF or IPC should not be high.

In practice, clients bear most of the costs of regulatory requirements through the fees and charges they pay. At least with compensation fund coverage, the clients would be getting a direct benefit for the costs imposed.

Market Confidence. The chief aim of making investor compensation funds available is to maintain investor confidence in the operations of their intermediaries and the market more generally. Investors have little control over how their assets are held and even less understanding of the potential impact of that decision. It is not consistent with the securities regulation objectives of protecting investors and promoting a fair and efficient market that clients whose assets have gone missing will be treated differently depending on the registration status of the intermediary with whom they were dealing. For example, some companies are both fund managers and MFDA Members. If one of those firms fail and client assets are missing, the assets that were supposed to be on the dealer's books are likely to be covered by IPC, while the client assets on the books kept by the company in its role as fund manager will not be covered. If there are weaknesses in the firm's bookkeeping, it will be a challenge to determine (a) which assets are missing, and (b) which clients are eligible for compensation. Explaining the outcomes to the public, while maintaining confidence in the system, will be an even greater challenge.

Fairness. In practice, all intermediaries gain a direct benefit from the maintenance of investor confidence in the markets provided by compensation fund coverage. Put another way, all would lose if investor confidence were lost. Fairness dictates that all participants who share the benefits that investor compensation schemes generate should share in the costs. It is noted that this concept helped the MFDA and CSA justify why all mutual fund dealers were required to participate in IPC, despite the fact that some categories of MFDA members posed very little risk because most of their clients' assets are held in client name at the mutual funds. Extending this rationale suggests that portfolio managers and fund managers also should be required to participate in a compensation fund.

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[8] Statistics from IFIC show the mutual fund assets under management by IFIC members have grown from $391 billion in 2002 to $697 billion in 2007, an increase of 78%.

Industry Arguments Against. To date, we note that whenever the topic of a 'fund for the entire industry' is raised, many fund managers argue that 'there have been no failures' or 'there is no risk to assets as we don't hold them' as support for their opposition to a compensation fund. Neither argument withstands scrutiny, as discussed above under the headings 'Access equals Risk' and 'Canadian Experience'.

How Participation Would Work

If a decision were made by the CSA that fund participation should be mandated for fund managers and portfolio managers, the next step would be discussions among the key stakeholders to develop the appropriate parameters for fund participation, including coverage policies and assessment methodologies. A collective effort and firm commitment by all stakeholders involved, including the CSA, would make it work.

Conclusions

Investor compensation fund participation should be required if a firm has access to investor assets. An investor compensation scheme serves as the final layer of investor protection in a securities regulatory system. It steps in to compensate investors for losses suffered after the regulatory mechanisms designed to prevent intermediary failures and protect client assess have proved to be inadequate to the task in practice. Risks to investors of these kinds of losses on the failure of a firm exist any time the firm handles, holds or has access to client assets. Virtually all investment fund managers and portfolio managers meet this test as it is described in the Companion Policy to NI 31-103, as virtually every registered firm would, at least, handle cheques in transit to or from investors. Acting as registrar and recordkeeper for an investment fund gives the investment fund manager a further dimension of control over investors' assets.

The amounts at risk are significant: more than $225 billion in mutual fund assets purchased by clients of MFDA Members are held at the investment funds and so not subject to IPC coverage; and the total amount of assets at risk is significantly higher when taking into account the assets under administration of all fund managers and portfolio managers. Market confidence and efficiency, fairness and, above all, suitable investor protection demands compensation fund coverage apply more broadly. In our view, it is imperative that fund managers and portfolio managers be required to participate in an investor compensation fund.