



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

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MFDA Bulletin

Policy

For Distribution to Relevant Parties within your Firm

Proposed MFDA Staff Notice on MFDA Member Intermediary Arrangements - Publication for Comment

The MFDA is publishing for comment a proposed Staff Notice which is intended to clarify requirements under MFDA Rules 1.1.3 (Service Arrangements), and 1.1.6 (Introducing and Carrying Arrangement). The Notice also addresses industry practices identified by MFDA staff, regulatory concerns, general principles to be taken into account by Members prior to entering into such arrangements, and other related matters.

Comments

Proposed MFDA Staff Notices may be published for public comment where, in the view of MFDA staff, it is appropriate to solicit broader stakeholder input in respect of the guidance set out in the Notice. When MFDA Staff Notices are published for comment, they will be posted to the MFDA website, along with individual submissions received in response to the request for input.

Members and other interested parties are asked to provide comments on the proposed MFDA Staff Notice, which is attached to this Bulletin. Comments may be sent by **May 7, 2018** (60 days from the issuance of this Bulletin) to:

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MFDA STAFF NOTICE

MFDA MEMBER INTERMEDIARY ARRANGEMENTS

MFDA Staff Notices are intended to assist Members and their Approved Persons in the interpretation, application of and compliance with requirements under MFDA By-laws and Rules. Notices make reference to these requirements and set out MFDA staff's interpretation of how to comply with these requirements. Notices may also include best practices or guidance.

The purpose of this Notice is to clarify requirements under MFDA Rules 1.1.3 (Service Arrangements), and 1.1.6 (Introducing and Carrying Arrangement). This Notice sets out general principles to be taken into account by Members prior to entering into such arrangements, and addresses regulatory concerns, and other related matters.

“Intermediary”, as used throughout this Notice, means: any financial institution (e.g. bank, dealer, or trust company), which has an arrangement with an MFDA Member dealer, for the purpose of facilitating transactions between the MFDA Member and a product issuer. As part of such an arrangement, the intermediary may provide one or a combination of services including, trade execution, custody, settlement, and/or record keeping.

I. Applicable MFDA Requirements

Rule 1.1.3

Under MFDA Rule 1.1.3(a), a Member or Approved Person may engage the services of any person, including another Member or Approved Person, to provide services to the Member or Approved Person, as the case may be, provided that:

“...the services do not in themselves constitute securities related business or duties or responsibilities that are required to be performed by the Member or Approved Person engaging the services pursuant to the By-laws, Rules or applicable securities legislation.”

Rule 1.1.6

Under MFDA Rule 1.1.6, a Member may enter into an arrangement with another Member pursuant to which the accounts of one Member (the "introducing dealer") are carried by the other Member (the "carrying dealer"), provided that such arrangements comply with requirements

under the Rule.

II. Practices Identified by MFDA Staff

As noted above, arrangements under MFDA Rule 1.1.6 may only be entered into by parties who are MFDA Members. Rule 1.1.3 permits a Member or Approved Person to enter into a service arrangement with any party, subject to requirements under the Rule.

During the course of its regulatory activities, the MFDA has observed situations where Members and/or Approved Persons have entered into relationships with intermediaries for the provision of services. In some cases, such services are provided under an Introducing/Carrying arrangement, pursuant to requirements under Rule 1.1.6 (i.e. where the intermediary is or becomes an MFDA Member). In other cases, Members seek to enter into a service arrangement, pursuant to requirements under Rule 1.1.3, for the provision of essentially the same services. In these cases, the intermediary is not an MFDA Member.

MFDA staff engaged in a more detailed review and evaluation of Member and Approved Person practices in this area, additional particulars of which are set out below.

III. General Considerations

In reviewing the arrangements entered into by Members and Approved Persons, MFDA staff took the following general considerations into account:

- Where and how are client assets held?
- Are clients receiving clear and fulsome reporting of their investments (i.e. in accordance with current requirements under MFDA Rules and securities legislation)?
- Could the arrangement give rise to client confusion (e.g. in relation to which services are being provided by the Member versus the intermediary)?
- Are clients receiving advice with respect to all investments with the intermediary and, if not, can the advisor effectively comply with his/her suitability obligation in such cases?
- Is the intermediary subject to regulatory oversight and, if so, by whom?
- If the intermediary is not a registrant under securities legislation, does this pose additional risk to investors?
- Is there a compensation fund in place to cover client losses in the event of insolvency?

IV. Intermediary Arrangements

(A) *Self-Directed Registered Savings Plans Administered by MFDA Members*

Mutual fund dealers who offer their clients self-directed registered plans enter into an arrangement with a trust company to act as the trustee for these plans.

- **Principal/Agent Agreement between Member and Trustee:** a common arrangement is where a Member acts as administrator for the plan under a bare trustee relationship. In these arrangements, the Member will enter into a principal/agent agreement with the trustee for the registered plans, and the Member will be responsible for all aspects of plan

administration, including trade execution, settlement, and maintaining the books and records for each client's registered plan.

- **Introducing/Carrying Arrangement between MFDA Members:** another common way that mutual fund dealers offer their clients self-directed registered plans, is through an introducing/carrying dealer arrangement where both parties are MFDA Members. In such arrangements, it is the carrying dealer who has the principal/agent relationship with the trustee of the registered plans.

In both types of arrangements noted above, client accounts are limited to holding investments in which the Member is able to trade or advise. The client has an account with a Member and does not have a direct relationship with the intermediary. All activity in client accounts at the Member is considered the business and responsibility of the Member.

(B) Intermediary Arrangements Administered by NRIs

Under Rule 1.1.3, Members may enter into service receiver/provider arrangements with other MFDA Members, or with entities that are not registered under securities legislation (i.e. Non-Registered Intermediaries - "NRI's").

In the case of a service receiver/provider arrangement, the NRI provides trustee/custodian services directly to the clients of the MFDA Member. Approved Persons may recommend that the client open an account with the NRI to allow the client to consolidate mutual fund securities with other investments which are not traded by or considered business of the Member.

The Member may send trade execution orders for clients either directly to the issuer or to the NRI, depending on the type of transaction. The NRI settles the trade and the assets are held in the registered account for the client at the NRI. Both the Member and the NRI prepare their own books and records, as the client is a client of both the Member and the NRI.

Investments other than mutual funds (e.g. publicly traded equities, limited partnerships and other exempt securities, GICs and segregated funds) can be purchased or transferred in and held in client accounts at the NRI. These investments may or may not be included on the Member's books and records depending on the Member's categories of registration or their view as to whether the investments were business of the Member. In such circumstances, clients have an account at the NRI which contains investments in respect of which the Member: (i) has provided advice; (ii) has not provided advice, or (iii) is not licensed to provide advice. The foregoing situation, in the view of MFDA staff, creates significant ambiguity, client confusion, and regulatory risk.

V. Regulatory Concerns

Set out below are regulatory concerns identified by MFDA staff in relation to intermediary arrangements noted in section IV.(B), above.

Unlevel Playing Field

MFDA Members who operate as carrying dealers offer essentially the same services to mutual fund dealers as the NRIs under the service receiver/provider arrangement. Two key differences are that: (i) carrying dealers are limited to holding and trading in securities in which both the introducing dealer and carrying dealer are licensed and able to trade; and (ii) in introducing/carrying arrangements, all activity within client accounts is the responsibility of an MFDA Member. Under service receiver/provider arrangements, the NRI provides an opportunity for clients to hold other investments within their accounts and creates the potential for confusion as to which party is responsible for advising on various investments within the NRI account.

Regulatory Jurisdiction and Standards of Conduct

An NRI is not a registrant subject to the jurisdiction of a securities regulator and, as a result, is not subject to the same regulatory requirements as a carrying dealer, including business conduct standards (e.g. supervisory standards, or complaint handling requirements). Further, securities regulators do not have the same ability to address regulatory issues that may arise with NRIs, as they do with MFDA Member carrying dealers.

Compensation Fund Issues

The mandate of the MFDA Investor Protection Corporation (IPC) requires it to meet specific requirements, including those related to customer protection, funding and maintenance, and risk management. NRI arrangements, as described above, make it more challenging to achieve these objectives. In part, this results from the potentially unlimited risk of loss to the IPC from assets that could be far in excess of the assets reported on MFDA Member books and records (which is the basis of determining adequacy of the IPC's fund size).

There are also significant differences in the nature and extent of coverage provided by an NRI and the IPC. For example, if the NRI is a federally regulated financial institution, client assets are provided insurance coverage under the Canada Deposit Insurance Corporation ("CDIC"). In the event of insolvency of the NRI, deposits in eligible accounts up to \$100,000 would be subject to CDIC coverage. IPC coverage is more extensive, as it covers property in the account of a Member, as defined in the IPC Coverage Policy, including securities, cash, and segregated funds up to \$1 million.

Clients may not be aware of the fact that when their account is with the NRI, and not a Member, coverage provided on their assets is materially less. Furthermore, clients may believe all assets in their account at the NRI are covered under the MFDA IPC policy when this may not be the case.

Potential for Approved Persons to Advise Beyond Limits of Registration

NRIs have arrangements with investment dealers that allow their clients (who are also clients of the MFDA Member) to trade in exchange traded securities and hold those securities in the same account as the mutual fund securities recommended by an Approved Person of the Member. The investment dealer does not provide any investment advice as a Delivery Against Payment

("DAP") account is established for the client for execution services only. Clients typically open accounts at the NRI on the advice of their MFDA Approved Person, who in many cases is the only financial advisor responsible for providing financial advice to the client.

Advising on Part of an Account

MFDA Approved Persons cannot advise on all securities that may be held in the account at the NRI. Consolidating mutual fund positions with other positions not sold through the MFDA Member results in Members and Approved Persons being unable to comply with their suitability obligations. An appropriate determination as to suitability requires a trade to be assessed by taking into consideration all positions within the account.

Client Documentation and Reporting

- ***Client Confusion - Account Opening Documents and Statements:*** NRI account opening documents may identify the MFDA Approved Person who is responsible for providing advice for the custodial account. NRI account statements may also disclose mutual fund securities sold by the MFDA Member and investments not sold by the Member and provide the name and contact details of the Member and Approved Person responsible for advising the client. It may, as a consequence, be difficult for clients to distinguish between the account and activity with the Member and their custodial account at the NRI.
- ***Performance Reporting:*** Clients of MFDA Members who have accounts at an NRI will receive an account statement from the Member. The account statement issued by the Member will disclose only those transactions and positions recorded on the books and records of the Member. Clients may have other transactions or investments in their account at the NRI which are not recorded on the books and records of the Member or reflected in the account statement issued by the Member. The performance report that Members are required to issue, in accordance with MFDA Rules and National Instrument 31-103 [Registration Requirements, Exemptions and Ongoing Registrant Obligations](#) ("NI 31-103"), may therefore only reflect a portion of assets in the client's portfolio holdings held at the NRI.
- ***Report on Charges and Other Compensation:*** The report on charges and other compensation that Members are required to issue, in accordance with MFDA Rules and NI31-103, requires disclosure of all operating charges related to the client's account and transaction charges in respect of a purchase or sale of a security. "Operating charge" means any amount charged to a client *by a Member* in respect of the operation, transfer or termination of a client's account and includes any federal, provincial or territorial sales taxes paid on that amount. "Transaction charge" means any amount charged to a client *by a Member* in respect of a purchase or sale of a security and includes any federal, provincial or territorial sales taxes paid on that amount. An NRI may charge clients operating and transaction charges. However, as these charges are not charged by or paid to an MFDA Member, they would not be required to be disclosed on an account statement, or included in the performance reporting calculation. However, where the same charges are applied in the same circumstances by a carrying dealer, the account statement, report on charges and other compensation, and performance report would reflect all operating and transaction charges paid by the client.

VI. MFDA Staff Position

Having regard to requirements under Rules 1.1.3 and 1.1.6, the general considerations taken into account by staff during its review, and the regulatory concerns noted above, MFDA staff is of the view that intermediary arrangements discussed under section IV.(B), above (i.e. those administered by NRIs) should be entered into as Introducing/Carrying Dealer arrangements, pursuant to requirements under Rule 1.1.6, as opposed to service arrangements under Rule 1.1.3.

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