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Autorité des marchés financiers

Consultation on the Regulatory Framework Applicable to the Mutual Fund Sector

Submission by Staff of the Mutual Fund Dealers Association of Canada

June 4, 2007

The Mutual Fund Dealers Association of Canada (“MFDA”) is pleased to respond to the “Consultation on the Regulatory Framework Applicable to the Mutual Fund Sector” dated February 2007 (“Consultation Paper”) by the Autorité des marchés financiers (“AMF”). We have organized our responses and comments on the Consultation Paper under the following headings:

1. Summary of Conclusions/Answers to Questions
2. MFDA and its Regulatory Role in Canada
 - (a) Structure and Function of the MFDA
 - (b) SRO Recognition in Canada
 - (c) Draft National Instrument 31-103
3. General Comments on Consultation Paper
 - (a) Objectives of Consultation Paper Proposals
 - (b) Quebec Legislation
 - (c) Customer Protection Funds
4. Recognition of MFDA in Quebec: Option 1 (questions 7, 8 and 9)
5. Recognition of MFDA in Quebec with CSF Outsourcing: Option 2 (questions 10, 11 and 12)
6. Recognition of CSF as Industry SRO in Quebec: Option 3 (questions 13 and 14)
7. Responses to Questions 1, 2, 3, 4, 5 and 6

In our responses we have adopted the defined terms as used in the Consultation Paper, except as otherwise defined.

1. SUMMARY OF CONCLUSIONS / ANSWERS TO QUESTIONS

- (a) **Recognition of MFDA in Quebec: Option 1.** The MFDA agrees with the option of being recognized as a self-regulatory organization (“SRO”) in Quebec with exclusive jurisdiction over mutual fund firms and representatives. Such recognition would be subject to specific terms and conditions similar to those that exist in other Canadian Securities Administrator (“CSA”) jurisdictions, including reporting obligations to and oversight by the AMF. It is acknowledged, however, that specific legislative requirements in Quebec would necessitate some differences in the terms and conditions. For example, such terms would refer to regulatory decisions relating to certain activities being exercised mainly by persons residing in Quebec. The MFDA also believes that appropriate transition provisions would be in order and the MFDA itself has adopted such transition provisions both when it was initially established and on the implementation of certain rules.
- (b) **Recognition of MFDA in Quebec with CSF Outsourcing: Option 2.** The MFDA agrees with the option of MFDA being recognized as an SRO in Quebec but has reservations with an outsourcing arrangement with the Chambre de la securite financiere (“CSF”). We are of this view for a number of reasons set out below including the fact that the proposed structure is not the optimal way to achieve the Consultation Paper’s stated objectives of modernizing, harmonizing and simplifying the regulation of mutual fund dealers.
- (c) **Recognition of CSF as Industry SRO in Quebec: Option 3.** MFDA has serious concerns with this option. Our comments on this option are based on the description of

the CSF proposal as set out in the AMF Consultation Paper and more fully detailed in both the April 2007 Information Circular issued by the CSF and its subsequent Submission to the AMF dated April 23, 2007. First, we note that one of the principal objectives of the Consultation Paper of simplifying the regulation of mutual fund dealers does not appear to be met by this option to the extent that two SROs are created. Second, to the extent that such option could have the effect of MFDA not being able to effectively regulate the operations of its more than 40 Members with operations in Quebec, MFDA would have serious concerns. In this regard, the general comments with respect to outsourcing made in respect of Option 2 are relevant. Third, MFDA questions how regulatory efficiencies will be enhanced by delegating mutual fund dealer regulation to the CSF in light of the fact that the CSF has no experience with such regulation and MFDA is currently the SRO which is performing this function not only in Quebec but also the rest of Canada. Fourth, the requirement for inter-regulatory approvals and cooperation among CSA members – not only for CSF, but also for MFDA - must be pursued to ensure it is accepted. Lastly, the stated benefits of the option emphasize market fragmentation in Quebec rather than national uniformity – this is not in the interest of the public or MFDA members.

- (d) **Question 1.** The MFDA is not aware of any disparities in the structures and operations of Quebec-based markets, including the distribution of mutual fund securities, which would account for or justify distinctions in the regulatory requirements as compared to other CSA jurisdictions.
- (e) **Question 2.** The MFDA has had experience with transition periods and believes that some minimal periods not exceeding two years may be appropriate in connection with compliance with certain rules and the payment of fees.
- (f) **Question 3.** The MFDA has no reason to believe that mutual fund dealers in Quebec could not, and should not, comply with the same capital requirements for mutual fund dealers carrying on business in any other CSA jurisdiction.
- (g) **Question 4.** The MFDA agrees with the proposal that financial institution bond coverage is a more suitable means of coverage for mutual fund dealers in Quebec than liability insurance.
- (h) **Questions 5 and 6.** The MFDA does not object to the repeal of the second paragraph of Section 149 of the SA, which would permit non-mutual fund dealer representatives to also be employed by a financial institution.

2. MFDA AND ITS REGULATORY ROLE IN CANADA

- (a) **Structure and Function of the MFDA.** The MFDA is the national self-regulatory organization for the Canadian mutual fund dealer industry. It was established in mid-1998 at the initiative of the Canadian Securities Administrators in response to the explosive growth of mutual funds in Canada in the late 1980's and a recognition among securities regulatory authorities that the mutual fund industry and investors would benefit from more robust regulation and effective oversight.

MFDA's operations, infrastructure, staffing and processes have evolved and developed over a period of several years leading to what is now an efficient and effective SRO in Canada. A detailed description of MFDA's structure and regulatory operations is attached at Schedule A. It is noted that developing an efficient and effective SRO takes a significant amount of time and resources and is not something that happens over night by simply adopting a rulebook and being designated as an SRO. This observation is relevant to the option proposed by the CSF and discussed in section 6 below.

- (b) **SRO Recognition in Canada.** The MFDA operates as an SRO in every jurisdiction in Canada. In several provinces of Canada (British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, and Nova Scotia), the MFDA has been formally recognized by the applicable securities regulatory authority which is a member of the CSA. Applications for SRO recognition have been filed in New Brunswick and Newfoundland and Labrador. SRO recognition is made by order of the applicable CSA member, which orders contain detailed terms and conditions that provide comprehensively for the basis on which the MFDA conducts its activities. In Quebec, the MFDA is not recognized as an SRO but has entered into a Co-operative Agreement with the AMF and the CSF dated December 15, 2004 pursuant to which the AMF and MFDA co-operate with respect to the examination and regulation of MFDA members operating in Quebec. The Co-operative Agreement also provides for referrals of complaints relating to Quebec based conduct directly to the AMF and CSF. This arrangement is working successfully in the view of the MFDA and is based in part on the principle of harmonization of regulation of mutual fund dealers across Canada.
- (c) **Draft National Instrument 31-103.** As indicated in the Consultation Paper, the consultation by the AMF is associated with the development and expected implementation of draft Regulation 31-103 respecting registration requirements ("Regulation 31-103" or NI 31-103"). The MFDA has participated in the discussions with members of the CSA and other SROs in connection with NI 31-103 and is familiar with its proposals. As a general comment in the context of the Consultation Paper, NI 31-103 is intended to be a national, harmonized instrument, one of the primary benefits of which will be to introduce uniform registration standards and standards of conduct for financial intermediaries across Canada. In particular, NI 31-103 anticipates that SROs such as the MFDA will implement and administer certain rules of conduct that are consistent with the instrument.

It follows from the foregoing objectives of NI 31-103 that both the establishment of standards of conduct by securities and mutual fund dealers and their administration and enforcement should be uniform. This conclusion would further suggest that a single SRO for the same classes of dealers across Canada would best serve the objective. This observation is relevant to the options for the SRO regulation proposed in the Consultation Paper and responded to in Sections 4, 5 and 6 below.

3. GENERAL COMMENTS ON CONSULTATION PAPER

- (a) **Objectives of Consultation Paper Proposals.** The MFDA agrees with the AMF's objectives as stated in the Consultation Paper "to modernize the current registration regime applicable to securities intermediaries and thereby help meet the need for

harmonization and simplification”. The objectives of the equality of treatment amongst securities intermediaries together with the reduction of disparities and regulatory inconsistencies are, in themselves, in the public interest. In the view of the MFDA, not only is such equality a matter of fairness but also it will assist Canadian capital markets to operate efficiently and be attractive to Canadian resident investors as well as foreign investors. The basis on which capital is accumulated and invested in all regions of Canada, including Quebec, is critical to the development of all such regions. The kind of uniform and fair regulation of securities intermediaries as proposed in the Consultation Paper benefits not only the member firms that are directly subject to them but also the investing public who are the customers of such firms and the users of the capital invested. To the extent that members of the MFDA are required not only to comply with different rules and standards but also to deal with multiple securities administrators, the overall system becomes less efficient. The proposed standardization, for instance, of firm solvency standards and the proficiency requirements to be administered on a passport system basis will significantly benefit members of the MFDA.

- (b) **Quebec Legislation.** The MFDA agrees with the proposal in the Consultation Paper that mutual fund dealers in Quebec become subject to the provisions of the *Securities Act* (Quebec) (“SA”) rather than the current *Act respecting the distribution of financial products and services* (“Distribution Act”). In the first place, this approach is generally the approach adopted by the other jurisdictions in Canada administered by members of the CSA and is not only familiar to members of the MFDA but is likely to achieve the greater harmonization of regulation that is sought. In the second place, and of more importance, is the fact that the regulation of mutual fund dealers and the administration of regulatory requirements applicable to such dealers are closer to and more compatible with that of the SA. Although there are some significant differences in the business of a mutual fund dealer from that of a securities dealer, the nature of the investment process and the history of the development of mutual fund firms have much in common with that of securities firms. Accordingly, MFDA believes that the regulation of mutual fund dealers in Quebec including MFDA members is best accomplished under the SA.
- (c) **Customer Protection Funds.** The Consultation Paper does not request comments on the structure and protection available to mutual fund customers under the *Fonds d’indemnisation des services financiers* (“FISF”) or the MFDA’s MFDA Investor Protection Corporation (“MFDA IPC”). It is recognized that while the funds provide different coverage, there is a possibility of overlapping coverage. Accordingly, a fair allocation of fees or dues payable by mutual fund members in Quebec and specifically the need to avoid duplication of fees must be considered. The MFDA looks forward to pursuing those discussions with the AMF but wishes to make two general observations.

First, the prudential regulation of financial intermediaries is directly related to the risks assumed by protection funds such as FISF and MFDA IPC. Although neither of such funds have any regulatory role, at least in the case of MFDA IPC the prudential rules of the MFDA applicable to its members and the manner in which they are enforced, are important risk management tools or considerations to MFDA IPC. Moreover, the extent of the risk that MFDA IPC is prepared to assume in respect of the insolvency of an MFDA member relates to the prudential requirements applicable to such members. As the AMF is aware through its participation, the MFDA IPC has recently had the benefit

of a report of a Working Group that has reviewed some of these matters. As specific examples, the fees or dues levied on members, the amount of the protection available to each customer and the size of the fund required to provide coverage are all directly related to the manner in which MFDA members carry on business and the rules and restrictions applicable to such business. Accordingly, although MFDA understands that the AMF is not soliciting comments on this general subject, MFDA believes that customer protection and the prudential rules applicable to mutual fund dealers cannot be separated.

Second, the Consultation Paper points out the fact that the customer protection offered respectively by each of FISF and MFDA IPC are different. The MFDA questions whether the broad coverage offered by FISF to customers of mutual fund dealers is sustainable in the long term. The experience of other jurisdictions may suggest that it is not. However, this conclusion need not lead to the result that an insolvency-based fund such as MFDA IPC would lead to customers of mutual fund dealers in Quebec being unprotected to an unreasonable degree. In fact, the experience of other insolvency-based funds, such as Canadian Investor Protection Fund, Securities Investor Protection Corporation in the United States and others around the world, illustrates that reasonable protection can be provided. Assisting in this prospect is the fact of the increased prudential requirements such as capital levels proposed in the Consultation Paper.

4. **RECOGNITION OF MFDA IN QUEBEC: OPTION 1** (questions 7, 8 and 9)

The MFDA agrees with the option of being recognized as an SRO in Quebec with exclusive jurisdiction over mutual fund firms and representatives.

Exclusive SRO. The recognition of the MFDA in Quebec with exclusive jurisdiction is the option that is most consistent with the objectives identified in the Consultation Paper of modernizing, harmonizing and simplifying Canadian securities regulation as it applies to mutual fund dealers and their representatives. In addition, this option is most consistent with the way in which the MFDA acts as an SRO in all of the other jurisdictions of Canada. The MFDA has been structured and organized on the basis that, within its regulatory authority, it has exclusive jurisdiction over its members and their representatives. Members of the CSA still have ultimate jurisdiction and authority over both (i) mutual fund firms and their representatives and (ii) the MFDA itself, pursuant to the relevant provincial securities legislation. However, the manner in which regulation occurs as between the MFDA and the various members of the CSA involves the relevant CSA jurisdictions placing a great deal of reliance on the MFDA's direct regulatory efforts and focusing on its oversight function of the MFDA with a view to ensuring that the MFDA is operating efficiently and properly in compliance with all of the terms and conditions of its SRO recognition order.

We agree that the registration of mutual fund dealers and representatives would continue to be performed by the AMF. This is consistent with the manner in which the MFDA operates in other CSA jurisdictions.

Terms and conditions. The MFDA believes that its recognition in Quebec should be subject to specific terms and conditions similar to those that exist in the other CSA jurisdictions that have recognized the MFDA. In this regard, we refer you to the Recognition Order and Terms and Conditions that have been made by the Ontario Securities Commission:

[http://www.osc.gov.on.ca/Regulation/Orders/2004/ord_20040521_226_mutualfunddealers.jsp].

The corresponding Orders in the other relevant CSA jurisdictions are substantially similar.

The MFDA is familiar with the legislation in Quebec relating to SROs as referred to in the Consultation Paper and we acknowledge that the legislation is slightly different than that which exists in other CSA jurisdictions. Accordingly, we also acknowledge that the specific terms and conditions that would pertain in Quebec would be somewhat different. For example, section 69 of the *Act respecting the Autorité des marchés financiers* provides that the power to make decisions relating to certain activities be exercised mainly by persons residing in Quebec. The MFDA would expect to comply with this kind of provision even though it is not a requirement in the other CSA jurisdictions. This would include having an office in Quebec with Quebec based staff with appropriate authority. MFDA corporate governance by-laws also provide the necessary flexibility to ensure that Quebec based dealers have appropriate representation on the MFDA's Board of Directors.

Transition periods. The MFDA has experience with transition periods both with respect to the implementation of a new regulatory regime and the introduction of specific new rules. As the AMF is aware, the MFDA was first recognized as an SRO in a number of CSA jurisdictions in 2001. Its initial membership comprised 224 mutual fund dealers across Canada including several conducting business in Quebec. The majority of new MFDA members had only been subject to a registration requirement and not been subject previously to active regulatory oversight. As a result, the matter of appropriate transition periods to adapt to a more robust regulatory regime had to be considered. In the first place, the development of the MFDA rules themselves took place on a consultative basis with industry over a 3-year period and members had ample opportunity to be aware of and plan for their implementation. In the second place, specific rules that required members to make operational changes were deferred for a reasonable period in order to permit members to comply.

In the case of the MFDA becoming recognized as an SRO in Quebec, we would expect a similar approach to apply to dealers in Quebec. Those mutual fund dealers in Quebec that are not MFDA members would require a period of transition for certain rules and a one or two year deferral, depending on the particular rule, may be in order. However, for those mutual fund dealers in Quebec who are already members of the MFDA, minimal transition provisions would be required because such dealers already comply or are able to comply with MFDA rules.

5. RECOGNITION OF MFDA IN QUEBEC WITH CSF OUTSOURCING: OPTION 2 (questions 10, 11 and 12)

The MFDA agrees with the option of MFDA being recognized as an SRO in Quebec but has reservations with the option of having an outsourcing arrangement with CSF.

Reasons for concern. The primary reason for this view is the fact that the proposed structure is not the optimal way to achieve the Consultation Paper's stated objectives of modernizing, harmonizing and simplifying the regulation of mutual fund dealers. Apart from not meeting the stated objectives in the best way, there are a number of other specific and, in the view of the MFDA, compelling reasons why the MFDA does not favour this model.

- **Regulation and enforcement.** The MFDA, like other SROs such as the Investment Dealers Association of Canada ("IDA"), operates on the basis that

self-regulation consists of a combination of rule making, monitoring of compliance and enforcement. To the extent that the option contemplates the outsourcing of MFDA enforcement with respect to representatives to the CSF, the underlying principle and effectiveness of the overall SRO process is diminished. In practice, the most effective regulation by the MFDA of its members and their representatives is the co-ordination of investigation and enforcement activities to encourage compliance and serve the public interest. It would be difficult to achieve this result if the functions are split as proposed in the option.

- ***Firms and representatives.*** Effective regulation of member firms and their representatives by the MFDA (and the IDA) recognizes that the conduct of member firms and their representatives is closely related and in most cases cannot be separated. Member firms are responsible for the conduct of their representatives; and representatives are also responsible to conduct themselves in a manner that is consistent with their member firm's compliance obligations. In practical terms, in compliance and enforcement matters the MFDA works with, and exerts its jurisdiction over, both member firms and their representatives. To split this function as proposed between the MFDA and the CSF would diminish the effectiveness of regulation of both member firms and their representatives.
- ***Accountability.*** The option contemplates the MFDA outsourcing functions to the CSF, meaning that the CSF would perform MFDA's functions in respect of representatives. This structure would require the MFDA to monitor the CSF's activities and ensure that the CSF is accountable to the MFDA in respect of the outsourced obligations. This proposal introduces serious risk with respect to MFDA, not only in terms of being responsible for the CSF's activities but, more importantly, ensuring that overall regulation of MFDA members and their representatives is consistent, effective and in the public interest.
- ***Costs and duplication.*** The option contemplates that there would be two administrative structures in place to regulate mutual fund dealers and their representatives in Quebec. This inevitably could add cost and duplication of functions to a degree, notwithstanding that the CSF may exist to continue its functions with respect to non-mutual fund representatives. The costs for this duplicative structure would be borne directly by the representatives and the mutual fund industry and, ultimately, by the public.

SRO Recognition terms and conditions. We refer to our comments under section 4 "Recognition of MFDA in Quebec: Option 1" with respect to the Terms and Conditions of the MFDA being recognized as an SRO in Quebec. The general principles under both options are the same. However, the Terms and Conditions under Option 2 of MFDA outsourcing functions to the CSF would require careful consideration. In our view, addressing the concerns referred to above with respect to this option could result in a relatively complicated and uncertain set of Terms and Conditions. In addition, the Terms and Conditions would have to be supplemented by appropriate agreements and protections as between the MFDA and CSF.

Transition periods. We refer to our comments under Section 4 "Transition Periods" above, which would appear to be generally applicable under this option.

6. RECOGNITION OF CSF AS INDUSTRY SRO IN QUEBEC: OPTION 3 (questions 13 and 14)

Concerns. MFDA has serious concerns with this option.

Our comments on this option are based on the description of the CSF proposal set out in the AMF Consultation Paper and more fully detailed in the April 2007 Information Circular issued by the CSF and its subsequent Submission to the AMF dated April 23, 2007. It is noted that certain aspects of the option as described are unclear or not fully developed and the MFDA would prefer to have more certainty with respect to the proposed model before making specific comments. Areas requiring clarification include the nature and extent of delegated functions by the AMF to either or both of CSF and MFDA; the relationship between CSF's dual role of a mutual fund SRO and a statutory regulator of other financial sectors; and potential cross-subsidization of CSF's regulatory functions among the sectors it would regulate.

However, certain general observations may be made. It should be stated at the outset that our views on the option are not meant to imply that the CSF is anything other than an effective and well regarded regulatory body.

- ***SRO Membership.*** One of the principal objectives of the Consultation Paper of simplifying the regulation of mutual fund dealers across Canada is clearly not served by this model to the extent that two SROs are created.
- ***Rules.*** In theory, it would appear that the object of harmonization of the rules applicable to mutual fund dealers and their representatives would be served by this model in the sense that the CSF and its activities including its rules would be harmonized with those of the MFDA. On the other hand, it is not clear whether the CSF would simply adopt all MFDA rules as and when made by the MFDA or whether it would have some independent role in that regard. It would be difficult to describe the CSF as an SRO if it did not have independent rule-making authority. Further, simple adoption of MFDA rules by the CSF would not ensure consistency of interpretation, application and enforcement of such rules.
- ***Separation of businesses in Quebec.*** The issue of co-ordinating rules and regulatory standards referred to in the foregoing paragraph recalls the circumstances that were required to be addressed by the MFDA and the then Bureau des services financiers (now the AMF) in respect of the current Co-operative Agreement. The Co-operative Agreement was developed as a practical and effective means by which MFDA members could maintain their operations in one corporate entity in all provinces of Canada. To the extent that the MFDA could not directly monitor and enforce compliance with its prudential rules by its members in Quebec, the alternative solution was to require the businesses of such members to be reorganized in separate corporate entities. The MFDA believes that all interests concerned agreed that that would have been an unfortunate result and not in the public interest. We believe the MFDA cannot effectively regulate and fulfil its mandate solely in reliance on another body and Option 3, which contemplates the CSF regulating MFDA members, appears to raise similar concerns.

- ***Lack of Dealer Regulatory Experience and Infrastructure.*** MFDA currently has an effective and proven regulatory infrastructure, including staff with appropriate experience and documented regulatory processes, necessary for effective dealer oversight. The same cannot be said for CSF, as CSF is not in the business of dealer regulation at all and has no track record in this regard. CSF's experience is limited primarily to individual representative discipline and continuing education.
- ***Legislative changes.*** Reference is made in the description of this option as to the CSF's organization and the requirement for substantial amendments to the Distribution Act. At present, the CSF is a statutory regulator. It is not a true SRO and does not operate as one. CSF does not have the essential aspect of an SRO, which, as stated above, vests rule making, monitoring and enforcement in its members (with suitable regulatory oversight). In this circumstance, it is not obvious to the MFDA why an attempt would be made to "convert" the CSF from a statutory regulator to an SRO. That process would predictably be very difficult and uncertain and a better approach would be to simply provide for the creation of a new SRO in Quebec. It may be that the Government of Quebec or the AMF are of the view that an SRO other than the MFDA is appropriate for recognition in Quebec. However, if this were not the case the result would support the implementation of option 1 or, possibly, option 2.
- ***MFDA IPC Concerns.*** We have not yet consulted with MFDA IPC as to the Consultation Paper and, as indicated, note that the details of whether or how investor protection would be coordinated between FISF and MFDA IPC must be developed. However, some general observations may be made. First, one of the primary risk management tools of an investor protection fund is a robust regulatory structure which minimizes dealer failures and possible losses to customers. To the extent that MFDA IPC would have to rely on outsourced functions from MFDA to CSF, the ability to ensure risks are adequately managed is reduced. As you may know, MFDA IPC and MFDA work very closely together and MFDA provides extensive services to or for the benefit of MFDA IPC. Parallel arrangements may have to be considered for MFDA IPC and CSF.

Second, the investor protection offered by each of FISF and MFDA IPC are quite different, although overlapping. In our view, the risk that there will be customer confusion as to the extent of coverage would increase significantly if CSF were identified with the regulation of both mutual fund dealers and the other financial services sectors under the jurisdiction of CSF. The ability to effectively describe and provide specific insolvency loss protection by both CIPF and MFDA IPC has been a major concern. Third, the integration of a fair fee model for MFDA IPC members – already a difficult task – will be further complicated. Notwithstanding the foregoing concerns, MFDA endorses the CSF's apparent view that restricting investor protection to insolvency losses (i.e., not other causes such as fraud) would be desirable.

Other comments. Pending the further detailed development of the CSF's proposal in Option 3, there are certain general observations that can be made. The proposal contemplates that regulators in provinces other than Quebec will subdelegate SRO powers to the CSF with respect

to dealers with head offices in Quebec. In addition, the proposal would require the approval of such regulators to the participation of either MFDA or MFDA IPC in the proposal. The MFDA has no knowledge or understanding of how other regulators would view the proposal and determining such views would be important before extensive time and resources are spent on developing the proposal. MFDA does not believe that the adoption of Option 1 would require the same inter-regulatory cooperation.

The CSF's proposal must be evaluated in light of its stated benefits such as: multidisciplinary expertise, Quebec specific expertise, innovative approach to ethics, Quebec regional presence, and knowledge of the milieu and Quebec legal framework. With great respect to CSF, the stated benefits seem to emphasize the fragmented approach to Canadian mutual fund dealer regulation, rather than the harmonized and uniform approach stated as an objective by the AMF. This result is not in the interests of the public or MFDA members. Moreover, the MFDA is not satisfied that it could not provide all such benefits and more under Option 1.

7. RESPONSES TO QUESTIONS 1, 2, 3, 4, 5 AND 6.

Question 1. The MFDA is not aware of any disparities in the structures and operations of Quebec-based markets, including the distribution of mutual fund securities, which would account for or justify distinctions in the regulatory requirements as compared to other CSA jurisdictions. There are a few non-regulatory legislative differences such as Quebec language and privacy laws but these distinctions are easily accommodated by financial intermediaries carrying on business in all parts of Canada and do not justify different regulatory treatment.

Question 2. We have commented on the matter of transition periods in Sections 4 and 5 above with respect to the first two option models. As indicated in that context, the MFDA has had experience with transition periods in not only commencing its operations but with respect to specific rules. While some relief for dealers and their representatives may be warranted in connection with compliance with rules and the payment of fees, the MFDA would not expect such transition periods to exceed two years.

Question 3. The MFDA has no reason to believe that mutual fund dealers in Quebec could not, and should not, comply with the same capital requirements for mutual fund dealers carrying on business in any other CSA jurisdiction. This issue was canvassed carefully (with some considerable controversy) during the establishment of the MFDA and these requirements remain under review from time to time both from the point of view of the operations of the MFDA and the protection provided by MFDA IPC. Again, appropriate transition periods may be in order but, in view of the magnitude of the sums, the maximum periods would not exceed two years.

Question 4. The MFDA agrees with the proposal that financial institution bond coverage is a more suitable means of coverage for mutual fund dealers in Quebec than liability insurance. As the AMF is aware, this is the approach taken by both the MFDA and the IDA. However, it should be noted that insurance coverage of any kind is last resort protection and the SRO system relies more heavily on robust rules and compliance in order to minimize losses. To the extent that the proposed change harmonizes the requirements for members across Canada, the proposal is consistent with the stated objectives of the Consultation Paper.

Questions 5 and 6. The MFDA does not object to the repeal of the second paragraph of Section 149 of the SA, which would permit non-mutual fund dealer representatives to also be

employed by a financial institution. As this is already the case for MFDA members, the change would not directly affect the MFDA or its members.

It may be noted as a general comment that the extent to which the financial intermediaries and their representatives are engaged in different financial sectors subject to different regulatory authorities, the difficulties and risks to effective regulation increase. Not only do conflicts of interest potentially arise as noted in the Consultation Paper, the matters of overlapping jurisdiction, confusion in the minds of the public, and, ultimately, the responsibility for financial losses, are affected.

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The MFDA looks forward to the results of the AMF's consultation and would be pleased to provide any further information that would be of use or otherwise participate in the process. In closing, MFDA would like to note that it believes that its regulatory efforts in Quebec have been very effective and this is a direct result of the collaborative working relationship that MFDA has had with both the AMF and CSF under the Cooperative Agreement. We share the AMF's desire to harmonize regulation of mutual fund distribution in Canada and look forward to our continued collaborative efforts in finding ways to achieve such harmonization.

Schedule A

Regulatory Structure and Functions of the MFDA

- (a) **Structure and Functions.** The MFDA is a not-for-profit members' corporation established under the *Canada Corporations Act*. It has a public interest mandate to serve as an SRO for mutual fund dealers in Canada and to protect customers of mutual fund dealers. The members of the MFDA comprise mutual fund dealer firms, which, in most provinces and territories of Canada, are required to be a member of the MFDA in order to be registered and authorized to conduct business as mutual fund dealers.

The MFDA performs no industry representation or trade association functions for dealer Members or salespersons. The MFDA is a pure regulator with a single purpose mandate reflected in its corporate vision:

Raising the standard of firm, fair and transparent regulation in Canada for the protection of investors through commitment to collaboration, staff excellence and regulatory best practices.

- (b) **Board of Directors.** The MFDA is governed by its members through a 13 person Board of Directors consisting of an equal number of mutual fund industry representatives and public or independent individuals, together with its President and Chief Executive Officer. The composition of the Board of Directors is required to reflect the diversity of the MFDA's membership (including nature of business model and location of head office) as well as the public interest through its independent directors.
- (c) **Regional Councils.** MFDA Regional Councils are a governance structure separate and distinct from the Board of Directors. There is a Regional Council in each of four geographic regions (Atlantic, Central, Prairie and Pacific) and each is comprised of:
- Elected representatives of Members in the applicable Region,
 - *Ex officio* representatives, and
 - Appointed representatives, comprising Public representatives with legal training and Industry representatives with securities industry experience.

The principal duties of the Regional Council in each Region are:

- The conduct of hearings by Hearing Panels created from among the representatives of Regional Council, and
- The consideration of policy matters.

MFDA disciplinary proceedings against a Member or Approved Person in a Region are conducted before an independent, impartial Hearing Panel comprised of 3 Regional Council representatives: one Public representative and two industry representatives. The Public representative, who serves as the Chair of each Hearing Panel, is either a retired

judge or a practising lawyer in Canada. This ensures that all MFDA disciplinary proceedings are conducted in accordance with the highest standards of procedural fairness. Neither members of the MFDA Board of Directors, nor MFDA staff, participate in the decision-making activities of Regional Council Hearing Panels.

MFDA Hearings are transparent and are conducted in public. Information respecting the Hearings is reported to the CSA, disseminated by news release and posted to the MFDA web site, for the benefit of public.

- (d) **Regulatory Operations.** The principal MFDA regulatory operations are Policy, Compliance and Enforcement:

Policy. Policy staff are active in monitoring the effectiveness of MFDA By-laws, Rules and Policies, all of which are designed to enhance investor protection. MFDA staff will recommend changes and draft new or amended MFDA regulatory instruments where appropriate. Staff also publish Notices and Bulletins for Members to assist with the interpretation of MFDA requirements and to advise Members of other important regulatory changes that may affect them.

Members are directly involved in the policy development process through (i) the MFDA's Policy Advisory Committee which is comprised of senior individuals from a broad cross-section of Member firms who review and comment on proposed policy instruments and provide suggestions to staff on other areas for policy development; (ii) the Regulatory Issues Committee of the MFDA Board of Directors which is comprised of industry directors and public directors and has a mandate of reviewing all proposed regulatory instruments recommended by staff and indicating to the MFDA Board whether they are supportive of the proposed instruments; (iii) the Member Regulation Forums which are held in several cities across Canada at least twice a year to discuss directly with Members proposed policy initiatives and obtain Member input and feedback on the initiatives and other areas of potential concern; and (iv) the public comment process – all proposed policy instruments are published for public comment and Members and Approved Persons have an opportunity to provide written comments, which are then reviewed by the MFDA and changes, where appropriate, are made to the proposed policy initiatives.

Compliance. The Compliance Department is comprised of approximately 65 staff operating nationally. Its primary responsibility is to monitor Member firms' compliance with MFDA Rules, By-laws and Policies. The Compliance Department is organized into 2 main groups:

Sales Compliance

This group is principally involved in conducting on-site field examinations of Member operations, at both head office and branch locations, and reporting and resolving findings.

The Sales Compliance group performs a sales examination of all Members and a combined sales and financial examination of Level 2 and 3 dealers. MFDA staff examine both a Member's head office as well as a sample of branch locations and coordinate

amongst the regional offices for multi-jurisdictional Members to obtain a complete picture of the firm's operations. MFDA Sales Compliance operates on a 3-year examination cycle and has established a benchmark to issue examination reports within 15 weeks for 70% of examinations and no later than 22 weeks for the remaining 30%. To date, the MFDA has completed its first 3-year examination cycle, is mid-way through its second cycle and has met its established benchmarks.

The first examination cycle resulted in a total of 392 locations being examined, including 189 head offices and 203 branches. This included 14 head office examinations performed in conjunction with staff of the AMF for Members headquartered in Quebec. As of April 30, 2007, MFDA has examined 158 locations as part of its second examination cycle, including 72 head office locations of which one was located in Quebec and 86 branch locations. For Quebec headquartered Members, the MFDA performs a routine head office examination and findings are shared between both AMF and MFDA staff as issues are identified. A French and English version of the MFDA examination report is provided to the AMF to include in one final reporting package provided to the Member.

Financial Compliance

This group is principally involved in reviewing Members' monthly and annual financial filings, performing on-site financial examinations of Level 4 dealers, and reviewing auditor working papers to monitor compliance with MFDA financial, insurance and internal control requirements. Financial Compliance staff perform an annual on-site examinations of all 44 current Level 4 dealers including 6 headquartered in Quebec. MFDA coordinates financial examinations with staff of the AMF and provides the AMF with a copy of its report identifying examination findings.

The MFDA has developed a web-based electronic filing system ("EFS") for the filing, tracking, consolidation and analysis of Member financial data. The EFS system provides for the most efficient method of obtaining and reviewing Member financial filings. More than 2100 monthly and annual financial reports are reviewed by MFDA staff on an annual basis.

The MFDA has also developed an integrated risk-model to assist in scheduling examinations and quantifying dealer risk. The risk-model captures information inherent to Members' operations as well as information obtained as a result of the MFDA's Enforcement and Compliance activities. The risk model assists in prioritizing Members for review, establishing materiality levels for financial examinations and will be used to identify risk trends.

Communications and Membership Services: The Communications and Membership Services group is active in maintaining Member files and responding to inquiries from Members, the public and the media. It is also responsible for maintaining and updating the MFDA website and facilitating Member events. Membership Services maintains and administers Member information by deploying the Membership Tracking System ("MTS"). MTS is a custom developed system for tracking and reporting on MFDA membership information data, including membership status, location, product, and

relationship data. MTS facilitates the MFDA's regulatory activities and supports enhanced reporting of membership information.

Enforcement. The Enforcement Department's key goal is to enforce compliance with MFDA regulatory requirements with a view to enhancing investor protection. It operates on several general principles:

- Actions are firm, fair and transparent,
- Members and Approved Persons are afforded an opportunity for input before a decision is made on disciplinary action, except in urgent cases involving potential public harm,
- In all cases, the level of supervision by the Member and its Approved Persons will be part of the review,
- Cases are reviewed proactively, with a view to identifying possible associated misconduct and assessing root causes,
- The Enforcement Department works on a cooperative basis with the Compliance and Policy Departments to refer cases and issues where appropriate, and
- The Enforcement Department works on a cooperative basis with Enforcement staff at securities commissions, other self-regulatory organizations and police agencies.

The Enforcement Department is organized into 3 main groups:

Case Assessment

This group responds to public inquiries and complaints and reports from other sources regarding potential violations. The group obtains information through correspondence and other means and conducts initial case assessments. The Case Assessment group escalates cases to Investigations where there are grounds to believe that there has been a substantial breach of MFDA requirements, or where the matter is sufficiently complex to require a more extensive review by an investigator.

Investigations

This group conducts in-depth reviews of cases, which includes gathering documentation, conducting interviews, analyzing cases and preparing reports and recommendations. The group also coordinates investigation activity with other regulatory and law enforcement agencies.

Litigation

This group conducts a legal review of potential litigation cases and is responsible for commencing disciplinary proceedings before Hearing Panels of Regional Councils, where appropriate.

Cases

The Department received 871 inquiries and opened 323 case assessment cases in 2006. 66 cases were escalated to Investigations and 12 to Litigation. Of the 279 cases closed during 2006, 129 were closed with a warning letter or other informal discipline.

Benchmarks

All three groups have benchmarks in place for case-handling, and the performance of those groups met those benchmarks in 2006. The benchmarks are:

- *Case Assessment* – 80% of cases will be closed or escalated within 120 days of case opening.
- *Investigations* – 80% of cases will be closed or escalated within one year of escalation to Investigations.
- *Litigation* – 80% of cases will be closed or the subject of an issued Notice of Hearing or Settlement Hearing within 10 months of escalation to Litigation.

- (e) **Staffing.** The MFDA currently has three operating offices located in Toronto, Calgary and Vancouver. The majority of the MFDA's approximately 150 staff are actively involved in compliance and enforcement activities, both of which have a strong investor protection orientation. MFDA has extensive expertise with mutual fund dealer operations and regulatory issues facing dealers and is consulted on a regular basis by its members and other regulators on such matters. MFDA's management team has collectively more than 75 years of direct work experience with a provincial securities regulator in Canada. MFDA compliance and enforcement staff receive extensive training on a regular basis with a view to ensuring that they are familiar with securities industry best practices as well as with the operations of MFDA's varied membership. MFDA staff are also trained to use a common sense and flexible approach to regulation recognizing that mutual fund dealers may adopt different procedures while still complying with the overall goal of investor protection.
- (f) **Membership Application Process.** The MFDA membership application process was initially designed to review and approve the over 250 mutual fund dealers across Canada on an expedited basis to establish the initial MFDA membership. During the establishment of its membership, the MFDA performed a desk review of all applications resolving issues through inquiry and exchange of correspondence. The process was subsequently revised to require more information to be submitted in the application and an on-site examinations to be performed given the fact that most new applicants are also new registrants.
- (g) **Collaboration with other Regulators.** MFDA is an active contributor in all major regulatory initiatives with other regulators in Canada. Examples of recent regulatory initiatives that MFDA has been involved in include the Registration Reform Project of the CSA (NI 31-103) and the Client Relationship Model project.
- (h) **Use of Technology.** MFDA has developed and employs state of the art technology systems in its operations including the following:

Membership Services: Member Tracking System ("MTS"): MTS is a custom developed system for tracking and reporting on MFDA membership information data, including membership status, locations, products offered, and relationship data. MTS facilitates the MFDA's regulatory activities and support enhanced reporting of membership information.

Electronic Filing System (“EFS”): EFS is a web-based electronic filing system for the filing, tracking, consolidation and analysis of Member financial data. The EFS system provides for the most efficient method of obtaining and reviewing Member financial filings. Because it is a web-based program, it can be accessed easily through a secured internet site and changes to the MFDA’s Financial Questionnaire and Report can be made immediately without the need for additional implementation measures.

Business Process Management System (“BPM”): The MFDA has developed an organizational business process management system. The MFDA uses the software to define, execute, and monitor MFDA business processes. Key benefits include: increased compliance with organizational procedures and policies; improved visibility and auditability of business process performance; and rapid deployment and optimization of organizational business processes. Process implementations will provide tracking of primary process data, key dates, including departmental benchmarks, actions and decisions made, and related documents.

Risk Model: The MFDA has developed an integrated risk-model to assist in scheduling examinations and assessing dealer risk. The risk-model captures information inherent to Members’ operations as well as information obtained as a result of the MFDA’s Enforcement and Compliance activities. The risk model assists in prioritizing Members for review, establishing materiality levels for financial examinations and will be used to identify risk trends. Information from the risk model is also a factor in the Enforcement case screening process.

Member Event Tracking System (“METS”): Mets is a web-based system for the reporting of significant enforcement and compliance and risk related information to the MFDA. METS will be implemented on July 1, 2007. It provides an efficient method for members to report information under MFDA Policy 6, including client complaints, criminal, civil and regulatory proceedings, bankruptcies, garnishments and other similar information. Reports will be screened by MFDA staff and followed up on where appropriate in relation to enforcement and compliance concerns. In addition, the information will be included in the MFDA member risk model analysis and information in the METS system will help to identify general trends and issues in the industry.

(i) **Regulatory Best Practices and CSA Oversight.** In fulfilling its regulatory mandate MFDA has developed and employs regulatory best practices in all of its operations, including compliance and enforcement. MFDA processes and operations are subject to ongoing and robust oversight by the recognizing CSA jurisdictions. In the past 3 years, MFDA has undergone two separate successful oversight reviews by the CSA in which CSA staff performed in depth reviews of MFDA regulatory processes and operations. The objectives of these oversight reviews were:

- To assess whether the MFDA is in compliance with the relevant terms and conditions of the order of each of the CSA jurisdictions that recognized the MFDA as an SRO.
- To determine whether the regulatory processes of the MFDA are efficient, effective, consistent and fair.

- To evaluate whether the MFDA has adequate staffing, resources and training processes to perform regulatory functions effectively and efficiently at each of its offices.

CSA staff concluded that MFDA was in compliance with its terms and conditions of recognition; were satisfied with the regulatory processes of the MFDA; and found no evidence that MFDA lacks any staffing, resources or training processes necessary to perform its regulatory functions efficiently and effectively.
