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

Contact: Steven Chen
Manager, Compliance
Phone: 416-943-7459
E-mail : schen@mfda,ca

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MFDA Bulletin

Compliance

For Distribution to Relevant Parties within your Firm

Performance Reporting Targeted Review

In 2020 the MFDA commenced a targeted review focused on performance data reported to clients by Members. This initiative was part of our continued efforts to use data and analytics to focus on risk areas and issues that are impactful to clients. The attached report provides a summary of the analysis and work performed during the review, our key findings and recommendations.

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1. Introduction

In 2020 the MFDA commenced a targeted review focused on performance data reported to clients by Members. This initiative was part of our continued efforts to use data and analytics to focus on risk areas and issues that are impactful to clients. While we regularly test performance reporting in our compliance examinations, the data obtained from the most recent Client Research Project provided valuable information that allowed us to conduct additional analysis and testing. This data included, for the first time, performance returns for all MFDA Member clients which allowed us to conduct a highly risk-based review of performance reporting specifically focused on accounts with unusual returns.

This report provides a summary of the analysis and work performed during the review, our key findings and recommendations. Where specific issues were identified with performance reporting for those Members included in the targeted review, Members were required to implement the necessary actions to address our findings. We are publishing the results of our targeted review for all MFDA Members and other industry participants so that they can consider the findings and recommendations and determine whether they need to take further action to ensure clients receive accurate performance data. We will continue to review Member performance reporting in our routine compliance examinations.

As further described under Screening and Member Selection below, this review was highly targeted and risk-based to focus on accounts that had highly unusual positive or negative returns. Therefore, the findings discussed in this report should not be considered to indicate that errors in performance reporting to clients are widespread or can be found in most accounts. Rather, where errors were identified they were often associated with specific circumstances or particular investments and therefore Members should implement regular testing of performance reporting focused both on these circumstances and accounts with highly unusual returns to identify any errors and take the necessary corrective action.

2. Screening and Member Selection Process

We began by reviewing the performance data submitted in the Client Research Project, which included performance returns for the year 2018, to identify unusual returns and select Members for further examination. This included looking for accounts with very large positive or negative returns and also comparing the reported returns to the investors' asset allocation to identify Members with a large number of specific client accounts with unusual returns. The selected Members were then asked to provide us with a risk-based sample of the annual performance reports sent to clients including 1) a sample of accounts with unusual returns in 2018 as compared to the investor's asset allocation and 2) a sample of the accounts at the Member with the highest and lowest reported performance returns for the year 2019. For these accounts we requested a copy of the performance reports and account statements for the relevant years to recalculate the account performance and analyze the cause of any unusual rates of return.

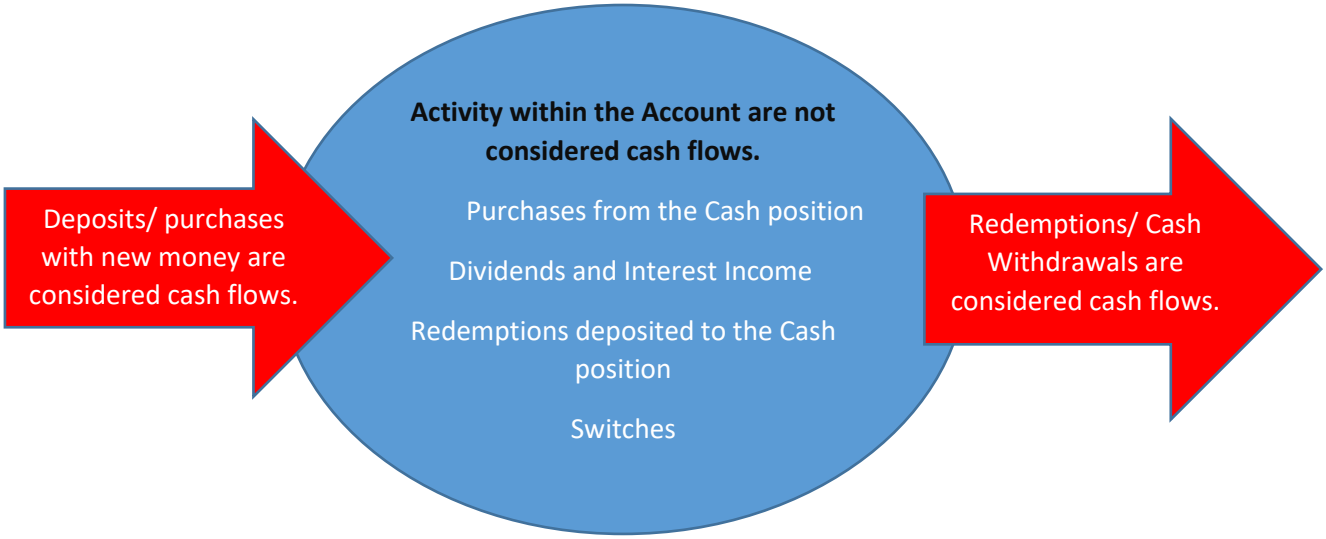
3. Understanding the Money-Weighted Rate of Return Calculation

MFDA Rule 5.3.4(iii) requires Members to use a money-weighted rate of return calculation method generally accepted in the securities industry.

The money-weighted rate of return methodology considers both the size and timing of cash flows in the calculation. When there is more invested in the account, the performance of those periods is given more

weight than periods when there is less invested in the account. Specifically it includes the impact of contributions to, or withdrawals from, the portfolio. In contrast time-weighted rate of return calculations remove the effect of cash flows.

Properly identifying and measuring cash flows is critical to an accurate money-weighted rate of return calculation. However, not all transactions in the account are considered cash flows for the purposes of the calculation. In general, transactions that bring in or take out monies from the account are considered cash flows. In addition, transfers of investments into and out of the account are considered cash flows. On the other hand, activities that occur within the account such as transactions to rebalance positions are not considered cash flows. Further examples of activity within the account that are not considered cash flows include purchases and redemptions within the account that do not alter the amount available to invest (e.g. switches within the account, purchases with the monies from the cash position of the account and redemptions where the proceeds are placed into the cash position of the account). In addition, returns on investments such as dividend, interest receipts or reinvestments and redemptions to pay account fees, such as an annual administration fees are not considered cash flows in the calculation.



4. Findings

We identified the following circumstances that caused unusual or incorrect reported performance returns. In light of the findings, noted below, Members should consider using a similar selection process as the MFDA outlined in Section 2 above to review and test annual performance reporting and investigate any unusual returns.

i) Incorrect Identification and Treatment of Transactions

Transactions that were incorrectly coded and treated in the performance return calculation caused unusual or incorrect performance reports. Specifically there were a number of incidences where account activity was improperly identified as a cash flow. In addition, in some cases not all transactions were properly captured (i.e. missing transactions). Examples of the issues we identified include:

- Switch trade in the same account where one side of the transaction is coded as either a purchase or redemption; (See Illustrative Example A)
- Reversals or adjustments coded as a purchase or redemption; (See Illustrative Example B)
- Maturing GIC and interest income coded as a new deposit; (See Illustrative Example C);
- Incorrect coding of transactions during back office system conversions;
- Not uploading all required transaction files onto the back office system;
- Not including end of reporting period transactions, including back-dated transactions, adjustments and reversals; and (See Illustrative Example D)
- Treating redemptions to fund account fee payments as cash flows (withdrawals) in the calculation. (See Illustrative Example E)

Illustrative Example A - (Switch trade where one side is coded as either a purchase or redemption)

A client has $50,000 in an account invested in two funds, Fund A and Fund B. On June 15, 2018, the client completed a $7,500 switch from Fund A to Fund B. There are no other transactions in the account and the year-end market value of the account is $55,000. Switch trades within the account are not considered cash flows in the money-weighted rate of return calculation and the correct money-weighted rate of return is:

Date	Amount	Description
01/01/18	50,000.00	Opening Balance
06/15/18	(7,500.00)	Switch-Out (not considered a cash flow)
06/15/18	7,500.00	Switch-In (not considered a cash flow)
12/31/18	55,000.00	Ending Balance
RoR	10.03%	

However, if the Member incorrectly coded the switch-in to Fund B as a new purchase (contribution), then the new purchase is treated as a cash flow in the money-weighted rate of return calculation and the incorrect reported return is:

Date	Amount	Description
01/01/18	50,000.00	Opening Balance
06/15/18	(7,500.00)	Switch-Out (not considered a cash flow)
06/15/18	7,500.00	Purchase (considered a cash flow)
12/31/18	55,000.00	Ending Balance
RoR	-4.63%	

Incorrect, understates RoR

If the Member instead incorrectly coded the switch-out from Fund A as a redemption (withdrawal), then the redemption is considered a cash flow in the money-weighted calculation and the incorrect reported return is:

Date	Amount	Description
01/01/18	50,000.00	Opening Balance
06/15/18	(7,500.00)	Redemption (considered a cash flow)
06/15/18	7,500.00	Switch-In (not considered a cash flow)
12/31/18	55,000.00	Ending Balance
RoR	27.19%	

Incorrect, overstates RoR

Illustrative Example B - (Reversals or adjustments coded as a purchase or redemption)

A client has an account with the Member. On June 15, 2018, the Member processed a $10,000 switch trade where the switch-in was processed incorrectly into Fund A. The Member identified the error and reversed the switch trade on June 19, 2018, where the $10,000 was invested into the correct Fund B. The reversal was incorrectly coded as a redemption and is considered a cash flow in the money-weighted calculation. There are no other transactions the account and the account had $50,000 at the beginning of the year and a year-end market value of $55,000, the correct money-weighted rate of return is:

Date	Amount	Description
01/01/18	50,000.00	Opening Balance
06/15/18	(10,000.00)	Switch-Out (not considered a cash flow)
06/15/18	10,000.00	Switch-In Fund A (not considered a cash flow)
06/19/18	(10,000.00)	Error adjustment Reversal Switch-In Fund A (not considered a cash flow)
06/19/18	10,000.00	Error adjustment Switch-In Fund B (not considered a cash flow)
12/31/18	55,000.00	Ending Balance
RoR	10.03%	

However, if the Member coded the adjustment in the account as a redemption (withdrawal) on June 19, 2018 rather than a reversal the incorrect reported return is:

Date	Amount	Description
01/01/18	50,000.00	Opening Balance
6/15/18	(10,000.00)	Switch-Out (not considered a cash flow)
06/15/18	10,000.00	Switch-In Fund A (not considered a cash flow)
06/19/18	(10,000.00)	Redemption Fund A (considered a cash flow)
06/19/18	10,000.00	Error adjustment Switch-In Fund B (not considered a cash flow)
12/31/18	55,000.00	Ending Balance
RoR	33.44%	

Incorrect, overstates RoR

Illustrative Example C - (Maturing GIC and interest income coded as a new deposit)

A client has an account with $20,000 invested in a $10,000 GIC with a 1.5% rate and $10,000 in Fund A. The GIC matured on June 30, 2018 and was deposited in the cash position of the account. There are no other transactions in the account and the year-end market value of the account is $20,150, the correct money-weighted rate of return is:

Date	Amount	Description
01/01/18	20,000.00	Opening Balance
06/30/18	10,150.00	GIC Maturity (not considered a cash flow)
12/31/18	20,150.00	Ending Balance
RoR	0.75%	

However, if the Member incorrectly coded the GIC maturity as a new deposit in the account the incorrect reported return is:

Date	Amount	Description
01/01/18	20,000.00	Opening Balance
06/30/18	10,150.00	GIC Maturity Deposit in Cash (considered a cash flow)
12/31/18	20,150.00	Ending Balance
RoR	-38.92%	

Incorrect, understates RoR

Illustrative Example D - (Not including end of reporting period transactions, including adjustments and reversals)

A client has an account with $60,000 invested in a $20,000 GIC and $40,000 in Fund A. The GIC matured on September 1, 2018 and a new GIC was purchased with the matured funds on the same date. At year-end the Member reported a market value of $40,000 for the account. On January 10, 2019, the Member identified that the GIC purchase was not recorded and thus processed an adjustment to record the $20,000 GIC purchase on September 1, 2018 and the adjusted year-end market value is $61,000. There were no other transactions in 2018 and the correct money-weighted rate of return is:

Date	Amount	Description
01/01/18	60,000.00	Opening Balance
09/01/18	20,000.00	GIC Maturity (not considered a cash flow)
09/01/18	20,000.00	Trade Adjustment: Purchase GIC (not considered a cash flow)
12/31/18	61,000.00	Ending Balance
RoR	1.67%	

However, if the Member does not record the trade adjustment and the related changes to the year-end market value as the trade adjustment was processed after the year-end, the incorrect reported return is:

Date	Amount	Description
01/01/18	60,000.00	Opening Balance
09/01/18	20,000.00	GIC Maturity (not considered a cash flow)
12/31/18	40,000.00	Ending Balance
RoR	-33.41%	

Incorrect, missing GIC value from trade adjustment

Illustrative Example E - (Treating redemptions to pay account fee as cash flows)

A client has $1,000 invested in a fee-based account and on June 30, 2018, $150 was redeemed from Fund A and deposited in the cash position of the account. On July 1, 2018 the $150 was withdrawn to pay for the annual account fee. There are no other transactions in the account and the year-end market value of the account is $1,100. The correct money-weighted rate of return is:

Date	Amount	Description
01/01/18	1,000.00	Opening Balance
06/30/18	150.00	Redemption (Not considered a cash flow)
07/01/18	150.00	Annual Account Fee Withdrawal (Not considered a cash flow)
12/31/18	1,100.00	Ending Balance
RoR	10.03%	

If the Member incorrectly includes the redemption of Fund A as a cash flow, the incorrect reported money-weighted rate of return is:

Date	Amount	Description
01/01/18	1,000.00	Opening Balance
06/30/18	150.00	Redemption (considered a cash flow)
07/01/18	150.00	Annual Account Fee Withdrawal (Not considered a cash flow)
12/31/18	1,100.00	Ending Balance
RoR	27.00%	

Incorrect, overstates ROR

ii) Using Incorrect Values for Investments

We identified instances where Members were using incorrect values for investments. This included situations where Members were:

- Not importing / updating / recording the correct market value of the investments in the account, this includes issues in the automatic and / or manual process required to update the market value; (See Illustrative Example F)

- Not reporting exempt securities at a correct market value, this includes using different valuation methods in different periods e.g. reporting the market value of an investment at book value at one year-end and at an actual market value in another year-end; and
- Recording transfer-ins at incorrect values such as book / carrying value rather than market value. (See Illustrative Example G)

Illustrative Example F - (Not recording the correct market value of the investments in the account)

A client has an account with $10,000 invested in Fund A. On June 30, 2018, the client purchased $10,000 in a flow through limited partnership which converts to a mutual fund after 12 months. The manufacturer publicly discloses the net asset value per unit monthly and Members are required to manually update the monthly value. There are no other transactions in the account and the year-end market value of the account is $18,000 ($10,000 Fund A and $8,000 in the flow-through LP), the correct money-weighted rate of return is:

Date	Amount	Description
01/01/18	10,000.00	Opening Balance
06/30/18	10,000.00	Purchase (considered a cash flow)
12/31/18	18,000.00	Ending Balance
RoR	-13.16%	

However, if the Member does not update the flow-through LP for the year-end market value and reports it instead at book value the incorrect reported return is:

Date	Amount	Description
01/01/18	10,000.00	Opening Balance
06/30/18	10,000.00	Purchase (considered a cash flow)
12/31/18	20,000.00	Ending Balance
RoR	0.00%	

Incorrect, overstates RoR

Illustrative Example G - (Recording transfer-ins at incorrect values)

A client has two accounts with the Member. Account A holds a position with a book value of $5,000 and a market value of $10,000 on June 30, 2018. The client consolidates the accounts by completing a $10,000 in-kind transfer-in of the funds from Account A to Account B on June 30, 2018. There are no other transactions in the account and the account had a beginning balance of $20,000 and the year-end market value of the account is $28,000 and the correct money-weighted rate of return is:

Date	Amount	Description
01/01/18	20,000.00	Opening Balance
06/30/18	10,000.00	Transfer-In at Market Value (considered a cash flow)
12/31/18	28,000.00	Ending Balance
RoR	-7.97%	

However, if the Member records the transfer-in kind at the $5,000 historical book value of the funds, the incorrect reported return is:

Date	Amount	Description
01/01/18	20,000.00	Opening Balance
06/30/18	5,000.00	Transfer-In at Book Value (considered a cash flow)
12/31/18	28,000.00	Ending Balance
RoR	13.40%	

Incorrect, overstates RoR

iii) Calculation Methodology

In some instances, Member performance reporting was incorrect as Members were:

- Not including all investments, including GICs and cash held in the account and the related transactions in the calculation; and (See Illustrative Example H)

- Using settlement / process date versus the trade date in the calculation.

Illustrative Example H - (Not including all investments and the related transactions in the calculation)

A client has an account with $147,000 invested in two Funds, $51,000 in Fund A and $96,000 in Fund B. On December 13, 2018, a switch was requested from Fund B to Fund C, however the switch into Fund C was processed on January 10, 2019 by the Manufacturer with a trade date of December 13, 2018. The $93,000 invested in Fund C was not included in the year-end balance for the purpose of the rate of return calculation (as this calculation was based on process date). However, the position was reported on the account statement. The Member reported the following rate of return.

Date	Amount	Description
01/01/18	147,000.00	Opening Balance
12/13/18	(93,000.00)	Switch Out (not considered a cash flow)
12/31/18	51,000.00	Ending Balance
RoR	-65.41%	

Incorrect, missing switch in understates RoR

However, the correct money-weighted rate of return is:

Date	Amount	Description
01/01/18	147,000.00	Opening Balance
12/13/18	(93,000.00)	Switch Out (not considered a cash flow)
12/13/18	93,000.00	Switch In (not considered a cash flow)
12/31/18	144,000.00	Ending Balance
RoR	-2.05%	

iv) Reporting

We also identified unusual performance returns where Members:

- Issued reports for dormant / inactive accounts with a zero year beginning balance but that are re-activated in the year and have a year-end balance; (See Illustrative Example I)

- Issued performance reports for accounts that were opened for less than 1 year (Note 1); and

- Issued performance reports for accounts that were closed during the year (Note 1).

Note 1: Members are not required to issue performance reports for accounts that are open for less than 1 year or for accounts closed during the year. Where performance reports are produced for periods less than a year, the returns may be unusual.

Illustrative Example I - (Reports for previously dormant / inactive accounts)

A client fully redeemed a TFSA account in June 23, 2017 however, the account remained active and on December 30, 2018 the client deposited $57,000 in the account and purchased Funds A and B. There were no other transactions in the account and the year-end market value is $56,870. The Member reported a -18.49% rate of return. The calculated money-weighted rate of return using a start date of December 30, 2018 is:

Date	Amount	Description
01/01/18	0.00	Opening Balance
12/30/18	57,000.00	Purchase
12/31/18	56,870.00	Ending Balance
RoR	-56.54%	

5. Other Observations

An additional source of unusual reported performance returns are related to the Money-Weighted calculation methodology itself. Unlike a time-weighted methodology, which removes the impact of cash flows when calculating rate of return, money-weighted rates of return calculate investment performance taking into account both the size and timing of cash flows, placing a greater weight on periods when the portfolio size is largest. Thus gains or losses can be particularly magnified for transactions that happen near the end of the year, especially where the late-year transactions are very large relative to the size of the account. As a result, there can be unusual returns even when there are no errors in the calculation. Members and Approved Persons should be aware that these unusual performance returns can occur with the money-weighted calculation in certain specific situations and should be prepared to discuss the rate of return with clients. (See Illustrative Example J)

Illustrative Example J (Unusual returns using the money-weighted methodology)

Part 1

A client has $1,000 in an account invested in one fund, Fund A at a unit price of $10. On December 28, 2018, the client purchased an additional $100,000 into Fund A at a unit price of $10. There are no other transactions in the account and the year-end market value of the account is $105,000. Therefore, there is a gain of $4,000 on a total investment of $101,000. The calculated money-weighted rate of return is:

Date	Amount	Description
01/01/18	1,000.00	Opening Balance
12/28/18	100,000.00	Purchase
12/31/18	105,000.00	Ending Balance
RoR	289.14%	

If the client had instead purchased the additional $100,000 in Fund A at a unit price of $10 on December 1, 2018, the calculated money-weighted rate of return is:

Date	Amount	Description
01/01/18	1,000.00	Opening Balance
12/01/18	100,000.00	Purchase
12/31/18	105,000.00	Ending Balance
RoR	51.70%	

For comparison, the Time-Weighted rate of return for both scenarios using the Daily Valuation methodology would be 3.96%.

Part 2

Assume instead the client had $50,000 invested on January 1, 2018 in Fund A at a unit price of $10 and then on December 28, 2018 purchased an additional $51,000 of Fund A at a unit price of $10. At December 31, 2018 the account had an ending balance of $105,000. As in Part 1, there is also a $4,000 gain and the money-weighted rate of return is:

Date	Amount	Description
01/01/18	50,000.00	Opening Balance
12/28/18	51,000.00	Purchase
12/31/18	105,000.00	Ending Balance
RoR	7.96%	

For comparison, the Time-Weighted rate of return using the Daily Valuation methodology would be 3.96%.

6. Key Recommendations and Best Practices

- Members are reminded to carefully review and test their annual performance reporting, as inaccurate reporting can impact investment decisions. Where unexpected or unusual returns are identified, Members should investigate such instances to identify the specific cause and determine the extent of any issue.

- Where Members identify inaccurate reported performance returns, Members should provide affected clients with a restated performance report for the time periods that were incorrectly reported.

- Members should select and document a sample of reported performance returns to review including:
  - accounts with exceptionally high or low reported performance returns;
  - accounts that hold different products such as GICs or exempt securities; and
  - accounts with non-typical transactions such as adjustments, reversals, back dating and inactive accounts.

- Members should ensure staff are adequately trained to accurately enter and process client transactions and to understand the potential impact on the reported performance returns to clients.

- Members should determine if they have complete and accurate records for investment products such as GICs and exempt securities that require manual inputs or the receipt of information from the issuer to record the investment transaction details and market values.

- Members should incorporate testing to ensure transactions are coded correctly as part of any back office system conversions.

- Members should have policies and procedures where accounts have been fully redeemed and inactive for a significant amount of time.

7. Further Steps

We will continue to carefully assess performance reporting in our examinations. Where we identify significant discrepancies and systemic issues with the reported performance data, we will ask Members to fully investigate the findings and to implement action plans to address the findings. Depending on the specific findings, Members may be asked to i) identify all clients that have been impacted, ii) develop procedures to address the underlying cause and iii) inform clients of the impact to them and disclose the corrected performance data.

Members with additional questions or those seeking guidance in enhancing their practices or remediating any performance reporting errors should contact their assigned MFDA Compliance Manager for further assistance.

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