2000/12/22 — MFDA Overview of Public Comments

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Overview of Public Comments on MFDA Application for Recognition and MFDA Response

The Public Comment Process

The MFDA's application for recognition as a self-regulatory organization, including the draft Rules and draft By-law, was published for public comment by the Alberta, British Columbia and Ontario Securities Commissions (the "Recognizing Jurisdictions") on June 16, 2000 for a 90-day comment period, which expired on September 14, 2000.

The Recognizing Jurisdictions provided a total of 427 individual comment letters to the MFDA. Comments were received from mutual fund dealers, industry groups and associations, individual salespersons and other members of the public.

During September and October 2000, MFDA staff read and summarized all the comment letters received in order to ensure that the concerns and opinions of all affected parties were fairly considered.

MFDA staff then worked with the MFDA Board Rules Committee to develop recommendations with respect to the comments received. The recommendations and responses to the comments adopted by the MFDA staff and the Board Rules Committee were then presented to and approved by the full MFDA Board on December 8, 2000.

The following is a general overview of the public comments with respect to material topics in the MFDA's draft By-law, Rules, Policies and Forms as well as the MFDA's corresponding response. Please note that many comments which were of a technical nature may not appear in this summary. However, they have been considered and addressed by the MFDA and, where appropriate, changes have been made to the By-law, Rules, Policies and Forms.

Anyone wishing to review the comment letters submitted should contact the relevant securities commission in their jurisdiction.

Annual Membership Fees

1. — Method of Assessment

Overview of Comments:

> Many commentators were opposed to AUA as the basis for assessing membership fees. Alternative methods for fee assessment were suggested such as revenues, number of

salespersons, number of accounts or a blended approach. Some commentators also felt that the minimum membership fee should be less than $3,000.

MFDA Response:

Fees, including the method of assessment, will be reviewed by the MFDA Board on a periodic basis. Initially, the Board has approved the AUA model.

On two previous occasions, the MFDA requested industry input on the method of assessing fees. This subject has been extensively reviewed and discussed by the Board. No issues were raised during the public comment process that had not already been considered by the Board.

The minimum fee was approved by the Board based on information provided by industry participants in the MFDA's Fee Model Workshops.

2. — Definition of Assets Under Administration ("AUA")

Overview of Comments:

Numerous comments were received on the proposed definition of AUA. In particular, many commentators felt that the definition of AUA should be restricted to mutual funds, and that other products which are subject to another regulatory regime, such as segregated funds, should be excluded.

A number of investment counsel/portfolio managers ("ICPM's") were of the view that the definition should not include assets that were regulated under their ICPM license.

Several commentators felt that money market funds should be excluded from the definition as they do not attract the same level of revenue as other securities.

There were also general questions as to what other securities were included in the definition.

MFDA Response:

To simplify the definition and recognizing that segregated funds are subject to another regulatory regime, the definition of AUA will be changed to include mutual funds only (including money market funds).

The MFDA understands that the Recognizing Jurisdictions may provide an exemption from their respective rules requiring membership in an SRO to certain ICPM firms that are also licensed as mutual fund dealers. The exemption will not be available to ICPM firms that distribute mutual funds pursuant to a prospectus directly to the public however. For ICPM firms that are not eligible for the exemption and are required to become MFDA Members, the definition of AUA will include all client mutual fund assets under administration.

Draft By-law

3. — Composition of the MFDA Board

Overview of Comments:

There were numerous comments on the composition of the MFDA Board. A majority of commentators felt that the role of IFIC and the IDA should be limited and/or eventually eliminated. These commentators also requested more representation from mutual fund dealers on the Board. Other commentators also felt that individual salespersons should be represented.

MFDA Response:

The current composition of the MFDA Board was determined by the Recognizing Jurisdictions. Both the IDA and IFIC agreed to the current Board composition at the direct request of the Recognizing Jurisdictions. The Recognizing Jurisdictions must approve any changes to the MFDA Board composition. The MFDA understands that the Recognizing Jurisdictions, as part of their conditions for recognizing the MFDA as an SRO, will require a review of the Board composition after the MFDA is fully operational (i.e. three years after all Members are accepted).

4. — Definition of "Dealer Business"

Overview of Comments:

Many commentators requested that the definition of "dealer business" be revised. In particular, the inclusion of financial planning and deposit instruments in the definition was viewed as problematic. There was both opposition to and support for the inclusion of "exempt securities" in the definition. Many commentators expressed confusion as to whether the MFDA Rules applied to all dealer business or only securities related activities.

MFDA Response:

The term "dealer business" will be replaced with "securities related activities" for greater clarity. All securities related activities (including exempt securities) must be conducted through the dealer.

Non-securities related activities which are *not* part of the business of the dealer, may be performed outside of the dealer by a salesperson provided the "dual occupation" provisions in the Rules are complied with. "Financial planning" is now referred to directly under the "dual occupation" section of the Rules.

Deposit instruments would be included in the definition of "securities related activities" to the extent that they constitute "securities" in some jurisdictions. However, at the request of the Recognizing Jurisdictions, deposit instruments are excluded from the requirements in draft Rule 1.1 relating to business structures.

5. — Directors' and Members' Meetings

Overview of Comments:

Directors' and Members' meetings should only be held in Canada.

MFDA Response:

Agree that meetings should only be held in Canada. The draft By-law has been amended accordingly.

6. — Ownership of Members

Overview of Comments:

The prohibition against any investor owning greater than 10% of a Member should be deleted. This prohibition is unnecessarily restrictive and does not provide additional investor protection.

MFDA Response:

Section 13.9 of the draft By-law does not prohibit an investor from holding 10% or more of a Member; it simply requires MFDA approval of any investor having 10% or more ownership in a Member. This section has been revised however, to require the MFDA be *notified* of any investor owning 10% or more of a Member (i.e. MFDA approval will not be required).

7. — Regional Councils

Overview of Comments:

The role of the Regional Councils is unclear.

The disciplinary process should be clarified.

Public members should not be limited to “legally trained” individuals.

MFDA Response:

Regional Councils will act as the authority for discipline and enforcement matters with respect to Members located in their region and will be representative of the Members in the region. Issues that are relevant to such Members' businesses, such as local business conditions or regulatory requirements, may also be discussed at Regional Council meetings.

Experience with other SRO's has shown that legally trained individuals are necessary for disciplinary hearings. Therefore, at least one legally trained public member should sit on every hearing, although not all public members will be required to have a legal background.

The MFDA is reviewing disciplinary hearing procedures in view of current industry initiatives regarding the creation of “Hearing Committees” and formalized Rules of Procedure regarding the conduct of hearings. If such procedures are approved by the CSA, the MFDA will consider adopting similar procedures to ensure consistency with the disciplinary proceedings of other SROs.

8. — Application Process

Overview of Comments:

The MFDA should amend the requirement for audited financial information to be not more

than 90 days old when applying for membership.

MFDA Response:

A transition period of one year will be in effect for Section 11.2.1 of the draft By-law. Therefore, for one year after recognition, only the most recently audited financial statements will be required. However, they must be supplemented with unaudited information.

Draft Rule 1 — Business Structures

9. — Commission Flow/Personal Corporations

Overview of Comments:

A significant number of commentators were opposed to the proposed MFDA Rule that requires payment of commissions directly to, and in the name of, the salesperson. These commentators indicated that unless the MFDA draft Rules were revised to allow salespersons' commissions to be paid directly by the dealer to unregistered service corporations, such Rules would be extremely prejudicial to current industry structures and result in significant harm to the industry. Many commentators also noted that such structures have been permitted by securities regulators to exist for many years. Various recommendations were made, including alternative structures, contractual arrangements and amendments to securities regulations, that would permit salespersons to continue to receive commissions through their personal corporations while ensuring that the regulatory concerns of the CSA and MFDA are also addressed.

MFDA Response:

The concept of an “incorporated salesperson” is not contemplated in existing securities legislation. The draft MFDA Rules published for public comment reflect the position of the CSA as outlined in a position paper issued in August 1999, that all commissions earned for the performance of registerable activities be paid directly by the dealer to the individual salesperson.

The CSA recently revised its original position in response to the public comments received. This revised CSA proposal would permit salespersons to direct dealers to pay a portion of their earned commissions directly to unregistered corporations provided that:

1. the portion of commissions paid to an unregistered corporation is related to the services (such services must not require registration) provided by the unregistered corporation to the dealer, and such portion is limited to no more than 25% of the total commissions earned by the relevant salesperson;

2. the services provided and the resulting remuneration must be reflected in an agreement between the dealer and the salesperson's corporation; and

3. all remaining remuneration, including remuneration resulting from activities for which registration is required, must be paid directly by the dealer to the salesperson.

The MFDA acknowledges that the CSA proposal attempts to accommodate, to a limited

degree, current business structures of prospective MFDA Members. However, the MFDA is of the view that the CSA proposal does not adequately address the business concerns of those dealers and salespersons who would be directly affected by the Rule. Therefore, the MFDA Rules have not been amended to reflect the revised CSA proposal.

Instead, draft Rule 2.4.1 requiring all remuneration to be paid by the dealer directly to the salesperson will remain unchanged but will be subject to a three year transition period from the date of recognition. During the transition period, dealers may pay commissions to unregistered corporations provided the unregistered corporation agrees to provide the dealer, the MFDA and the regulators access to its books and records.

The transition period will afford the CSA sufficient time to work with the industry and consider this matter further and will also provide MFDA Members sufficient time to restructure their operations in the event the CSA determines that existing industry structures must be altered.

Furthermore, the MFDA is supportive of the industry's intent to advocate legislative or regulatory change that would accommodate current industry structures.

It is important to note however, that although MFDA Members will have three years to comply with the MFDA's Rule requiring the payment of commissions directly to salespersons, Members will still be required to comply with all of the other MFDA Rules in effect. That is to say, the payment of commissions by a Member to an unregistered corporation does not diminish the Member's obligations under the MFDA's Rules. For instance, Members will still be required to have a written agency agreement with those Approved Persons acting as agents, reflecting the provisions outlined in the Rules. Further, Members will be responsible for supervising all of their Approved Persons in accordance with the requirements in the MFDA Rules and Policies (including registered sales assistants) regardless of the remuneration arrangement in place.

10. — Administrative Assistants

Overview of Comments:

Many commentators felt that salespersons should be permitted to compensate their registered sales assistants either directly or through their personal service corporations. Several commentators suggested that a special category of registration should be provided which would allow for proper supervision and compensation through salary and overrides.

MFDA Response:

The MFDA and the CSA are not contemplating the creation of a separate category of registration for registered sales assistants. In any event, developing a separate category of registration would not permit a salesperson to pay a registered sales assistant for a registerable activity. Under draft Rule 2.4.1 commissions must be paid directly to salespersons by the dealer. As noted above however, the MFDA is recommending a three-year transition period before draft Rule 2.4.1 becomes effective. Notwithstanding any remuneration arrangements, the Member is responsible for supervising all persons whose

license it sponsors, including registered sales assistants.

11. — Introducing/Carrying Arrangement (Alternative Structures)

Overview of Comments:

Several commentators indicated that the introducing/carrying dealer model set out in the draft Rules is not sufficient to meet the needs of the majority of dealers in the mutual fund industry who use the services of intermediaries. The development of an alternative carrier dealer category was suggested in order to accommodate intermediaries who wish to provide services to Level 2, 3 and 4 dealers.

Commentators suggested that draft Rule 2.1.2 be amended to include a provision that requires all Approved Persons to place all trades and conduct all activities in furtherance of a trade through the facilities of the Member only. It was submitted that Approved Persons should not be allowed to place trades directly with mutual fund companies and intermediaries.

MFDA Response:

The MFDA has developed an alternative carrying dealer model for intermediaries providing services to Level 2, 3 and 4 dealers that is reflected in the revised draft Rules. This will permit trade execution and settlement, record keeping, issuing client statements, and custody of cash and securities, as long as the intermediary is registered as a mutual fund dealer with the relevant securities commission and is a Member of the MFDA.

The MFDA has amended draft Rule 1.1.1 (a) to include reference to “through the facilities of the Member” in order to ensure that all trades are placed through the Member only.

12. — Trade Names

Overview of Comments:

The MFDA received numerous comments that salespersons should be allowed to use their own trade names. It was submitted that requiring dealers to own the trade names of salespersons would cause a significant loss of identity and goodwill to existing businesses. Various recommendations were made that would permit salespersons to continue to use their own trade names with conditions imposed to ensure that regulatory concerns are addressed.

MFDA Response:

Consistent with the recently announced position of the CSA regarding the use of trade names, the MFDA has amended its draft Rules to permit salespersons to use their own trade names provided certain conditions are met such as prior approval by the dealer, notification to the regulators and using the name in conjunction with the dealer's name. However, only the dealer's name may be used on account statements, contracts and trade confirmations.

13. — Proficiency Requirements

Overview of Comments:

Several commentators suggested that there should be a transition period for the experience and course requirements for branch managers. These commentators indicated that many dealers will not likely have individuals currently available with the requisite proficiency or experience requirements when the MFDA is recognized.

Commentators also felt that there should be a transition period for the course requirements for trading partners, officers, directors and compliance officers.

It was also suggested that the course requirements outlined in draft Rule 1.2.1(a) should include predecessor courses such as the Principles of Mutual Fund Investment Course previously provided by the Trust Institute.

MFDA Response:

The MFDA agrees that transition periods should be provided to allow sufficient time for Members to meet the proficiency requirements prescribed under the Rules. The transition periods will be as follows:

- Two-year transition period for experience requirement for branch managers. There will be no experience requirement for alternate branch managers.
- One-year transition period for course requirements for branch managers, including alternates, where branch managers are not already required.
- One-year transition period for course requirements for trading partners, officers and directors of introducing dealers (Level 1).

The MFDA has also revised draft Rule 1.2.1(a) to include predecessor courses.

14. — Dual Occupations

Overview of Comments:

Many commentators expressed confusion over what is required to supervise the non-securities related business activities that Approved Persons may carry on outside the dealer, such as insurance. Several commentators expressed the view that the dealer's responsibility for supervision should be limited to “dealer business”.

MFDA Response:

Draft Rule 1.2.1(d) on “Dual Occupations” has been clarified to require the dealer to be aware of and approve of Approved Persons engaging in outside business activities, in addition to establishing and maintaining procedures to ensure continuous service to clients and to address potential conflicts of interest. In addition, Rule 1.2.1(d) provides that clear disclosure be given to clients that any such outside activities carried on by the Approved Person are not being offered by the Member.

15. — Financial Planning

Overview of Comments:

A large number of comments were received on the topic of financial planning. Many commentators opposed requiring financial planning activities to be conducted only through the dealer. Commentators also requested clarification on the supervisory responsibilities of dealers with respect to financial planning activities. Many commentators were of the view that the role of the MFDA should be limited to regulating financial planning activities that relate directly to securities transactions and to ensuring compliance with the CSA's proposed proficiency requirements.

MFDA Response:

The MFDA is of the view that non-securities related financial planning activities should be treated in the same fashion as any other outside business activity that a salesperson is legally able to engage in outside the dealer. In other words, financial planning activities that do not constitute trading in securities that are not the business of the dealer and are carried on by a salesperson outside the dealer will be subject to the MFDA requirements for "Dual Occupations" (draft Rule 1.2.1(d)) with two additional requirements: (1) the dealer and the MFDA must have access to financial plans that are prepared on behalf of clients of the dealer by its Approved Persons; and (2) the dealer must ensure that the Approved Person has satisfied any applicable proficiency requirements promulgated by securities regulatory authorities having jurisdiction.

Note: The MFDA understands that the Recognizing Jurisdictions may also require that any such non-securities related financial planning activities may be carried on by a salesperson outside the dealer only (i) through an otherwise regulated entity (e.g. insurance agency) or (ii) where the salesperson is a member of a regulated profession (e.g. accounting professionals).

16. — Business Titles

Overview of Comments:

Several commentators felt that draft Rule 1.2.1(f) was too vague and that clear guidelines are needed regarding the specific business titles sales representatives may use when holding themselves out to the public. It was suggested that titles and designations be developed that denote not only the educational background but also the product capability of the individual.

MFDA Response:

Specific business title guidelines will not be developed at this time. The MFDA needs more experience with its membership in order to determine if this is an issue appropriate for further consideration.

17. — Changes in Registration Information

Overview of Comments:

Several commentators opposed certain notification requirements in draft Rule 1.2.5. Commentators questioned why the MFDA needs to be notified of matters dealing with the

registration of salespersons since it will not be handling registration. It was also submitted that the term “any criminal laws” in draft Rule 1.2.5(e) is too broad and that an element of materiality should be included in the Rule, such as requiring notification in the event of a charge with respect to an indictable offence. Commentators also felt that the requirement for immediate notification in the event of being declared bankrupt or making a voluntary assignment in bankruptcy is problematic.

MFDA Response:

Rule 1.2.5 has been amended to require notice of (i) a change in address for service, (ii) a change in information previously filed, and (iii) bankruptcy. The MFDA proposes to enter into information sharing arrangements with the Recognizing Jurisdictions in order to eliminate duplicate filings.

The MFDA agrees with the second comment and has amended the Rule by deleting the reference to “charge”.

With respect to the requirement for immediate notification of bankruptcy, the MFDA feels that immediate notification of such an event is crucial given the potential impact on clients and other MFDA Members through claims against the MFDA Investor Protection Plan.

18. — Confidential Information

Overview of Comments:

Commentators expressed concern with the requirements in draft Rule 2.1.3 that client consent to the disclosure of confidential information be “written”. It was suggested that the definition of “written” should be included in the Rules and expanded to include electronic, taped or other forms of consent. It was suggested that an exception should be provided where disclosure of the information is reasonable necessary to provide a product or service.

One commentator noted that the second paragraph of Rule 2.1.3(a) as drafted, appeared to permit the Member or an Approved Person to use confidential information for improper advantage, provided the client gave written consent. The commentator suggested that the reference to “improper advantage” should be amended to read “advantage”.

MFDA Response:

The MFDA agrees that the consent obtained from the client should not be restricted to “written” consent. It will be left to the dealer to decide how consent will be evidenced. Draft Rule 2.1.3(a) has been amended to delete the reference to “written” consent.

In addition, the MFDA agrees that an exception to the requirement for consent should be made where the disclosure of client information is reasonably necessary to provide a product or service.

Draft Rule 2.1.3 has been revised to delete the reference to “improper” advantage.

19. — Conflict of Interest

Overview of Comments:

Some commentators indicated that the MFDA conflict of interest provisions in Rule 2.1.4 are unworkable, as there is no means to determine what types of conflicts need to be disclosed and the comprehensiveness of any required disclosure. These commentators suggested that a companion policy should be drafted with examples of what types of conflicts need to be disclosed and the nature of the disclosure required.

MFDA Response:

The MFDA is of the view that the conflict of interest provisions in draft Rule 2.1.4 are appropriate. Determining whether there is a conflict of interest should be left up to the dealer since it is a question of fact in every case.

Draft Rule 2 — Business Conduct

20. — Client Accounts

20.1 — General Comments:

Numerous comments were received on the topic of client accounts. Several commentators suggested that MFDA Members who qualify as discount mutual fund dealers and do not provide advice to clients should not be subject to suitability obligations.

It was submitted that the requirement for client signatures on new account application forms (“NAAF's”) should be removed or electronic signatures should be permitted.

Several commentators suggested that clarification is required in the draft Rules regarding the need to obtain “Know-Your-Client” information as part of the NAAF. It was noted that many dealers use separate KYC forms in addition to NAAF's.

MFDA Response:

With respect to the comment that exceptions from suitability obligations should be made for discount mutual fund dealers and unsolicited trades, the MFDA does not have the jurisdiction to exempt its Members from such a requirement. Suitability obligations reflect the current regulatory standard imposed by securities laws and the securities commissions will decide whether to permit an exemption from such requirements for unsolicited trades and discount mutual fund dealers.

The MFDA disagrees with the suggestion that the requirement for a client signature on the NAAF be removed. The MFDA will consider the issue of electronic communications and signatures post-recognition in the context of broader industry initiatives.

The MFDA has revised the draft Rule to reflect the fact that KYC information may be located on documentation other than the NAAF.

20.2 — New Account Approval

Overview of Comments:

Rule 2.2.3 should be amended to allow for electronic and online approval of new accounts.

MFDA Response:

Draft Rule 2.2.3 has been amended to require the approval of new accounts and that evidence of such approval be maintained. This should allow sufficient flexibility for electronic approvals in this area.

20.3 — Updating the NAAF

Overview of Comments:

Numerous commentators opposed the requirement that the NAAF be updated annually. Several commentators indicated that the requirement in draft Rule 2.2.4 to obtain written authorization for changes in the client's name or address is too restrictive, particularly for address changes.

MFDA Response:

The MFDA has revised draft Rule 2.2.4 to delete the requirement for annual updates. However, draft Rule 2.2.4 requires Members to annually request in writing that clients notify them of any material changes to the client's circumstances or to the know-your-client information previously provided. This is in addition to the existing requirement to update know-your-client information whenever the Member becomes aware of a material change.

The requirement in draft Rule 2.2.4 to obtain written authorization for changes in the client's address has been removed from the draft Rule.

21. — Powers of Attorney

Overview of Comments:

Some commentators were opposed to draft Rule 2.3.1, which prohibits dealers from accepting general powers of attorney.

MFDA Response:

The MFDA believes that the prohibition on general powers of attorney should be maintained, as the risk associated with general powers of attorney outweighs the benefits. The use of limited trading authorizations is permitted and this should provide sufficient flexibility.

22. — Limited Trading Authorization

Overview of Comments:

Many commentators were opposed to the requirement that every trade that is made under a limited trading authorization be reviewed by a branch manager.

There were also numerous technical comments and recommendations regarding the limited

trading authorization form. Commentators requested that the form be shortened, simplified and use plain language. It was also suggested that the informational page should be placed before the form.

MFDA Response:

Draft Rule 2.3.3 has been amended to provide that each trade made pursuant to a limited trading authorization and its corresponding account be identified as such in the books and records of the Member and on any order documentation. The MFDA policy on account supervision has also been revised to require that only a sample of trades made pursuant to a limited trading authorization be reviewed.

Draft Rule 2.3.2 requires a form of limited trading authorization as prescribed by the MFDA. The limited authorization form attached to the draft Rules is identical to IFIC's authorization form released on August 28, 2000. The MFDA will issue a notice advising Members that IFIC's Limited Authorization Form and Guidelines thereto will be the form prescribed by the MFDA for the purpose of complying with Rule 2.3.2.

23. — Remuneration, Commissions and Fees

Overview of Comments:

Many commentators were opposed to the requirement in draft Rule 2.4.1 that all remuneration in respect of dealer business conducted by an Approved Person be paid directly to and in the name of the Approved Person.

MFDA Response

The MFDA will provide a three-year transition period before draft Rule 2.4.1 becomes effective. (For further discussion of this issue, please refer to section 9 herein entitled “Commission Flow/Personal Corporations”).

24. — Referral Arrangements

Overview of Comments:

A number of commentators requested that referral arrangements include lawyers and accountants.

MFDA Response:

The MFDA understands that lawyers and accountants are prohibited from entering into referral arrangements by their respective professional associations and, therefore, the draft Rule has not been changed.

25. — Minimum Standards of Account Supervision

25.1 — Branch Managers

Overview of Comments:

A number of commentators were opposed to the requirement for on-site branch managers and alternate branch managers. It was submitted that the draft Rule was too rigid given that delivery structures are changing rapidly and geographical and office locations are no longer relevant benchmarks.

Several commentators also indicated that the availability of qualified individuals to fill the role of an alternate branch manager is limited. It was suggested that the MFDA waive the two-year experience requirement for alternate branch managers to expand the number of eligible registrants.

MFDA Response:

The MFDA draft Rule requiring branch managers is consistent with current securities law requirements.

The experience requirement for alternate branch managers will be deleted and they will not be required to be on-site. Draft Rule 2.5.3(c) has been clarified by adding the word “temporarily” before the word “absent”.

25.2 — MFDA Account Supervision Policy

Overview of Comments:

Commentators questioned the amount/degree of supervision and review that should be done at the head office level versus the branch level under the proposed Policy. Some commentators suggested that the policy on account supervision should not prescribe specific elements of supervision programs/compliance reviews, but should state general goals and allow Members to develop their own risk-based program.

MFDA Response:

The MFDA has revised the account supervision policy to provide further clarification regarding branch and head office reviews. Head office reviews should be focused on unusual activity or reviews that cannot be carried out at the branch level. The MFDA is of the view that in order to provide sufficient guidance to Members it should prescribe the minimum elements of a supervision program and not simply state the general goals.

26. — Leveraged Securities Trades

Overview of Comments:

Some commentators felt that the requirement to provide a risk disclosure statement to the client upon becoming aware of a client's “intent” to employ borrowed monies is too onerous and subjective.

Several commentators indicated that Members should be able to use alternative forms of their own design in a form approved by the MFDA.

MFDA Response:

The MFDA has amended draft Rule 2.6 to require that disclosure is given to clients on account opening, or when an Approved Person recommends that the client borrow money to purchase securities or otherwise becomes aware of a client actually borrowing money to purchase securities.

The MFDA will allow Members to use their own forms as long as they contain language prescribed by the MFDA. The MFDA has prepared a Notice regarding such prescribed language.

27. — Advertising and Sales Communications

Overview of Comments:

An issue raised by several commentators was the responsibility of dealers for materials produced by third parties. It was submitted that Members should only be responsible for advertisements and sales communications produced by them and not for third party materials passed on by Members to clients.

The requirement to have all advertisements approved by a partner, director, officer, compliance officer or by a branch manager designated by the Members, was viewed by some commentators as too restrictive.

MFDA Response:

The general restrictions in draft Rule 2.7 regarding the use of untrue and misleading advertisements will be maintained. There should be some standard of accountability for all materials distributed by Members.

With respect to the review requirement, the MFDA believes that this is a reasonable and necessary control procedure.

28. — Personal Rates of Return

Overview of Comments:

Many recommendations were received regarding methods for reporting rates of return. Several commentators suggested that the MFDA endorse specific methods as acceptable for reporting rates of return while other commentators criticized such methods.

MFDA Response:

Rule 2.8.3 continues to require disclosure of the methodology used and does not endorse a particular methodology. The draft Rule has been revised to require that rates of return provided in a client communication for a specific account or accounts should be an “annualized” rate of return.

29. — Policies and Procedures Manual

Overview of Comments:

Several comments were received regarding the requirement under draft Rule 2.10 for Members to establish and maintain a written Policies and Procedures Manual. It was submitted that a Policies and Procedures Manual is an unnecessary expense. Other commentators felt that the dealers should be able to maintain the Policies and Procedures Manual in electronic form. It was also suggested that the MFDA recommend essential policies that should be included in the manual.

MFDA Response:

The requirement to establish and maintain a Policies and Procedures Manual is a necessary internal control to ensure compliance with the Rules, Policies and By-laws of the MFDA and applicable securities legislation. Members may maintain their Policies and Procedures Manual in electronic form. After recognition, the MFDA will consider issuing a notice providing guidelines regarding the topics that should be covered in a Policies and Procedures Manual.

30. — Complaints

Overview of Comments:

Many comments were received regarding the definition of “complaint”. It was suggested that the term “complaint” be restricted to complaints received in writing or via e-mail regarding dealer business. Another commentator felt that the term “complaint” should not include complaints that have been resolved to the client's satisfaction.

MFDA Response:

The term “complaint” is defined in the MFDA's complaint handling policy. Although the definition of complaint refers to only written complaints, the policy provides that certain verbal complaints based on their nature and severity should be handled in the same manner as written complaints. The MFDA does not agree that the term “complaint” should exclude complaints that have been resolved to the client's satisfaction, as MFDA complaint procedures should be carried out before complaint resolution in any case.

31. — Account Transfers

Overview of Comments:

A large number of general as well as detailed comments were received, including specific comments on the flow of account documentation and processing. There was both opposition to and support for “bulk transfers”. Those commentators who supported bulk transfers recommended allowing the bulk transfer of accounts by way of negative confirmation. Other commentators suggested that bulk transfers should be allowed only in special circumstances, such as dealer takeovers.

MFDA Response:

In response to the comments, the MFDA has reconsidered its draft Rules on account transfers.

The MFDA believes that further industry input on current practices should be obtained in order to develop explicit transfer procedures. An industry committee will be formed after the MFDA is recognized for this purpose. Consequently, the detailed procedural provisions of the draft Rule have been deleted. It is still the view of the MFDA however, that, as a general rule, the transfer of client accounts should be allowed only if the client has authorized the transfer in writing. This general principle has been reflected in the amended Rule.

Exemptions to the general rule requiring client authorization may be permitted under special circumstances. Members may apply to the MFDA for an exemption from the client authorization rule to allow “bulk transfers” in the case of mergers, acquisitions and internal reorganizations. The MFDA will also issue a notice that the CSA intends to allow “bulk transfers” by way of negative confirmation for agents that establish their own dealership within two years after the MFDA is recognized where the dealer and agent have agreed to such a transfer. During this time, an Approved Person may obtain a negative confirmation of a client's intent to transfer provided the accounts are in client name.

Draft Rule 3 — Financial and Operations Requirements

32. — Minimum Capital Levels

Overview of Comments:

Many commentators did not appreciate the difference between risk adjusted capital and working capital. Some commentators that did acknowledge the difference were opposed to a risk adjusted capital approach to the capital calculation as it is too onerous. Commentators generally were also of the view that the minimum capital levels were too high. A majority of commentators supported the MFDA's transition periods.

MFDA Response:

The capital calculation has been amended to an approach more similar to a working capital approach. The minimum capital levels for Levels 2 and 3 dealers have been reduced from $75,000 and $125,000 to $50,000 and $75,000 respectively. The MFDA will provide a one year transition period for Level 1 dealers and a three year transition period for Levels 2, 3, and 4 dealers to attain the required minimum capital levels.

33. — Margin Accounts

Overview of Comments:

There was both opposition to and support for allowing MFDA Members to offer margin accounts to clients.

MFDA Response:

The MFDA is not in favour of allowing margin accounts for Members at this time. If the MFDA allowed Members to provide margin accounts, it would necessitate a more onerous capital calculation and higher minimum capital requirements. A number of commentators

were of the view that the capital calculation and minimum capital amounts as drafted were too financially onerous. Increasing the capital requirements to allow only a few Members to offer margin accounts would negatively impact a majority of potential Members. In addition, prior to allowing such a practice, the MFDA would have to be satisfied that the industry supports such an initiative and is willing to be financially responsible to the MFDA Investor Protection Plan for all Members offering such accounts.

34. — Advancing Mutual Fund Redemption Proceeds

Overview of Comments:

Some commentators were of the view that requiring the client to direct the issuer to pay redemption proceeds to the Member would be problematic for accounts held in nominee name. In addition, some commentators advised that the requirement for prior written confirmation from the issuer in advance of the payment of proceeds did not conform to current industry clearing and settlement practices.

MFDA Response:

To address the issues noted above, the draft Rules no longer require a direction from the client to the issuer. The requirement for prior written confirmation from the issuer has also been deleted. The Member must still, however, receive prior confirmation that the order has been accepted by the issuer. Confirmation may be obtained electronically.

35. — Related Company Guarantees

Overview of Comments:

Several commentators misunderstood the definition of “related company” in the draft By-law which defined related companies as MFDA Members. Some commentators assumed that “related companies” included companies that were not MFDA Members.

In addition, commentators submitted that the guarantee should be limited to obligations to clients in the event of insolvency.

There was also some confusion as to what the term “capital employed” referred to.

MFDA Response:

To clarify that guarantees relate only to Members, the term “related company” has been changed to “related Member”.

The draft Rules have also been amended to clarify that the guarantee relates to obligations to clients in the event of insolvency.

The term “capital employed” has been replaced with “total financial statement capital” which corresponds to a line item on Statement A of Form 1.

36. — Trust Accounts

Overview of Comments:

There was general opposition to the requirement to maintain separate trust accounts for mutual fund securities and other securities or financial products.

There was also opposition to the requirement that the trust account earn a market rate of interest.

Some commentators recommended that a carrying dealer should be able to maintain one trust account for introducing dealers.

MFDA Response:

The requirement to maintain one trust account for mutual funds and separate trust accounts for other financial products reflects the requirements of National Instrument 81-102.

The draft Rule has been amended to require a trust account to bear interest at rates equivalent to comparable accounts of the financial institution.

The comments indicated that there is some confusion regarding trust account requirements for carrying dealers. The draft Rules require a carrying dealer for a Level 1 introducing dealer to maintain a trust account to hold the introducing dealer's client funds. It is not intended that the carrying dealer will have to maintain separate trust accounts for each introducing dealer for the purpose of holding each introducing dealer's client funds. However, carrying dealers are required to hold any deposit provided by an introducing dealer of its own funds that is to be used against any obligations it owes to the carrying dealer (i.e. a comfort deposit), separately and in trust for each introducing dealer. The draft Rules will be amended to clarify the above distinction between comfort deposit requirements and client funds requirements.

37. — Financial Reporting

Overview of Comments:

Various recommendations were made regarding the frequency of financial reporting. Many commentators felt that monthly financial reporting was unnecessary and too onerous.

Commentators also recommended the filing deadline for the monthly report and the annual report be extended.

MFDA Response:

The MFDA will provide a transition period of two years relating to the monthly reporting requirement. During this time, the MFDA will require quarterly reporting but will retain the right to require more frequent financial reporting if a Member's circumstances deem it necessary. After the two year transition period, the MFDA will consider whether to continue to allow quarterly reporting to continue.

The draft Rules have been amended to require the monthly financial report to be filed within 20 business days of the month-end and the annual financial report to be filed within 90 days of the Member's financial year-end. During the two year transition period such reports must be

prepared quarterly and filed within 20 business days of the end of the quarter.

38. — Early Warning Requirements

Overview of Comments:

There was concern that the early warning requirements as set out in the draft Rules would place a number of Members in early warning needlessly and that the tests in the draft Rules were not entirely applicable to mutual fund dealers.

MFDA Response:

The early warning tests have been amended to help ensure Members will only trigger early warning in appropriate circumstances. The MFDA will delay the implementation of the automatic early warning sanctions for two years after recognition in order to allow Members to become familiar with the new capital and early warning requirements. However, the MFDA will retain the ability to impose sanctions if it deems it necessary in certain circumstances. As well, during the two-year transition period, the MFDA will be collecting financial information from its Members and will be able to analyze and assess the early warning requirements using such information to ensure they are appropriate.

39. — Auditor Experience

Overview of Comments:

There was a concern that dealers located in smaller communities may not be able to retain an auditor with five years of industry experience. It was submitted that this would force dealers to retain larger accounting firms and could significantly increase audit costs. As well, some commentators felt it would terminate dealers' existing relationships with their auditors.

MFDA Response:

The MFDA has removed the five year industry experience requirement in the draft Rules. The MFDA's objective is to ensure that a Member's auditor is aware of the regulations pertaining to the Member, especially as it relates to the financial position of the Member and the internal controls and procedures that safeguard assets of the Member and its clients. Accordingly, a Member's auditor will be required to sign an Acknowledgement and Agreement to the MFDA. The Acknowledgement and Agreement requires the engagement partner to attest to the fact that he or she has read and understood certain sections of the MFDA's Rules, Policies and Forms and agrees to comply with such Rules, Policies and Forms.

40. — Financial Questionnaire and Report

Overview of Comments:

The financial questionnaire and report was generally thought to be too complex and confusing.

MFDA Response:

The definitions in the financial questionnaire and report have been amended with a view to clarifying and simplifying the form. However, the information requested in the questionnaire has not been changed as it is necessary to ensure Members are complying with the MFDA's regulatory requirements.

41. — Acceptable Institutions as Registered Account Trustees

Overview of Comments:

Some commentators were of the view that the MFDA should not require a trustee that holds client assets in registered accounts to be an "acceptable institution" that maintains a minimum of $100 million in paid up capital. One commentator supported the $100 million requirement.

MFDA Response:

The definitions in the MFDA Financial Questionnaire and Report have been amended to remove the $100 million paid up capital limitation. It was recognized that adopting the $100 million requirement would cause a significant negative impact to existing arrangements in the industry.

Draft Rule 4 — Insurance

42. — Amount of Financial Institution Bond Coverage

Overview of Comments:

Many comments were received that questioned the need to increase the minimum bonding requirements under securities legislation. It was also suggested that the "base amount" concept be removed.

MFDA Response:

The draft Rules have been amended to provide more flexibility. Instead of simply requiring a flat $200,000 for Level 1 and 2 dealers and $500,000 for Level 3 dealers as one of the factors in determining the minimum requirement, it will be $50,000 per Approved Person up to $200,000.

The "base amount" calculation remains as the other factor in determining the minimum coverage amount because it takes into consideration the value of assets held by the dealer that are at risk.

43. — Errors and Omissions Insurance

Overview of Comments:

Many commentators supported mandating errors and omissions (E&O) insurance. Many of these commentators, however, only supported mandating E&O on the presumption that it should replace other prudential requirements, such as minimum capital, bonding and investor protection plan participation.

MFDA Response:

The MFDA generally agrees that E&O coverage would be a positive compliment to the other prudential requirements under the MFDA Rules. Prior to mandating such coverage, however, there are certain issues that must be addressed, such as the definition of coverage, the prospects of every MFDA Member obtaining coverage and the establishment of a group plan. As such, the MFDA proposes to establish a committee after recognition to review E&O issues and develop specific recommendations.

E&O insurance is not however, a suitable replacement for capital, financial institution bonding or contingency fund participation. While each requirement is complimentary, their purpose and objectives are different.

44. — General Requirements

Overview of Comments:

Commentators felt that the requirement under draft Rule 5.1.8 for Members to retain "all communications" received was too broadly worded and inconsistent with current industry practice.

MFDA Response:

The MFDA agrees that Rule 5.1.8 was too broad and it has been deleted.

Draft Rule 5 — Books and Records

45. — Client Account Statements

45.1 — Delivery by Approved Persons

Overview of Comments:

Approved Persons should be prohibited from preparing any *ad hoc* statements to clients that purport to be account statements of the Member or in substitution of the account statement required to be sent by the Member.

MFDA Response:

The draft Rules have been amended to expressly state that Members may not rely on Approved Persons to satisfy their obligation to send client account statements.

45.2 — Frequency of Delivery for Client Name Accounts

Overview of Comments:

There was significant opposition to the Recognizing Jurisdictions' proposal to require monthly and quarterly delivery of client account statements. Several commentators were also of the view that mutual fund dealers operating in client name should be allowed to rely on the fund companies to send client account statements.

MFDA Response:

The requirement for dealers to send an annual account statement is a requirement under existing securities legislation in a number of jurisdictions. Members should be required at a minimum to provide the client with an annual account statement outlining all securities transactions executed by the Member on behalf of the client.

However, the MFDA recognizes that many dealers do not currently send client account statements and would not be able to comply with such a requirement immediately. Therefore, the MFDA will allow a two year transition period for Members to send statements, provided the Member satisfies itself that the mutual fund companies are sending account statements.

45.3 — Frequency of Delivery for Nominee Name Accounts

Overview of Comments:

Some commentators opposed the monthly reporting requirement and recommended various other options for frequency of delivery. The suggestion was made to exclude the monthly reporting requirement where the "entry in the month" is automatic in nature, such as dividend reinvestments.

MFDA Response:

Existing delivery requirements for nominee name accounts will be maintained. A Member that holds client assets in its own name should be required to report to clients on a more frequent basis than for client name accounts. The draft Rules will be amended however, to exempt certain automatic transactions from the monthly delivery requirement, such as dividend reinvestments and automatic deposits.

45.4 — Content

Overview of Comments:

Several comments were received regarding the content requirements for account statements under draft Rule 5.3.3. Commentators opposed the requirement that the account statement include the name of the Approved Person since many clients do not have one Approved Person managing their account. It was also submitted that the requirement for the "date the statement was issued" is unnecessary since draft Rule 5.3.3(c)(iv) already requires the "period covered by the statement" and timelines are explicitly defined in draft Rule 5.3.1.

MFDA Response:

The MFDA agrees that the requirement to include the name of the Approved Person servicing the account may not be applicable in all circumstances and has amended Rule 5.3.3 accordingly. With respect to the second comment, the MFDA disagrees that the requirement to include the date the statement was issued is unnecessary. The experience of other self-regulatory organizations has shown that this is relevant and important information that should be included on an account statement.

45.5 — Consolidated Account Statements

Overview of Comments:

There was opposition to the requirement that only transactions executed by the Member may appear on the account statement. Generally, commentators were of the view that consolidated statements should be allowed provided adequate disclosure was made to identify which transactions were executed by the Member.

MFDA Response:

The draft Rules have been revised to permit consolidated account statements provided:

- there is clear disclosure of the legal entity through which transactions were executed and which assets are held by the Member;
- there is clear disclosure with respect to which products are, and which products are not, entitled to protection plan coverage;
- there is a disclaimer that the Member cannot verify the accuracy of the information regarding transactions executed or assets held, by other entities; and
- any disclosure is in accordance with other applicable legislation.