

**13.1.2 Request for Comments – MFDA Policy 5
Regarding Branch Review Requirements**

**MUTUAL FUND DEALERS
ASSOCIATION OF CANADA
POLICY 5 - BRANCH REVIEW REQUIREMENTS**

I. OVERVIEW

On September 14, 2005, the MFDA Board of Directors approved MFDA Policy 5, which is intended to clarify MFDA requirements with respect to minimum standards for Member branch review procedures.

A. Current Rule

There are currently no specific standards contained in the MFDA By-laws, Rules and Policies with respect to branch review requirements.

Under MFDA Rules, Members are responsible for and required to supervise the conduct of each Approved Person in respect of Member business. MFDA Policy 2, in particular, requires Members to conduct an on-going review of sales compliance procedures and practices both at head office and at branch offices to ensure that adequate supervision is being completed. Further, Members are responsible for establishing, implementing and maintaining policies and procedures to ensure the handling of its business is in accordance with the By-laws, Rules and Policies and with applicable securities legislation. MFDA Rule 2.9 requires each Member to establish and maintain adequate internal controls. The requirement to complete regular branch reviews is consistent with these obligations.

B. The Issues

MFDA staff have observed that some Members have not implemented branch review procedures that are sufficient to allow them to meet their supervisory obligations. The MFDA has developed a proposed policy to provide guidance regarding the MFDA's minimum expectations with respect to branch reviews, while allowing Members sufficient flexibility to develop procedures that are appropriate to the particular Member's size and business model.

C. Objectives

The proposed policy was developed to ensure that certain minimum standards are observed by Members in monitoring branch compliance. It will require Members to implement a formal branch review program that prescribes criteria for branch selection, review procedures, reporting of results and proficiency requirements for branch reviewers.

The objective for each Member is to develop a branch review program that maximizes the ability of the Member to detect potential problems, so that corrective action may be promptly taken.

D. Effect of Proposed Amendments

By requiring that effective branch review programs be in place, the ability of Members to assess and monitor the quality of supervision employed at their branches will be enhanced. Members will be better able to ensure that branch managers have a complete understanding of their fundamental supervisory requirements and to provide ongoing education of staff and Approved Persons with respect to compliance issues.

Members that do not presently have adequate branch review procedures in place will be required to make appropriate arrangements. As a result, some Members may incur additional costs.

It is not expected that the proposed amendments will have other significant effects on Members, other market participants, market structure or competition or that the proposed amendments will require Members to implement significant technological systems changes to comply with the proposed policy.

II. DETAILED ANALYSIS

A. Relevant History

The MFDA Rules currently require Members to perform an adequate level of supervision of their branch locations. To assess Member compliance with this requirement, MFDA staff review Members' policies and procedures regarding branch reviews when conducting Member compliance examinations.

The proposed policy was developed to give Members more detailed guidance in complying with their obligations with respect to monitoring branch supervision. Certain basic requirements must be satisfied by all Members to ensure that they can have a good understanding of the adequacy of their branch supervision systems.

B. Proposed Policy

Each Member will be required to implement a branch review program that allows the Member to assess the supervisory procedures employed at its branches, as well as the quality of execution of those procedures. The review process must involve interviews with supervisors and other individuals as well as substantive testing, including a review of client files and trade blotters. The reviewer must verify that there is proper documentation of the required know-your-client information on file and proper evidence of client instructions. Evidence of supervisory reviews must be reviewed to confirm that trade reviews have been performed in a timely fashion and the quality of review is consistent with head office standards and regulatory expectations. The branch review program must also address other regulatory concerns, such as sales communications, referral arrangements, outside business activities and complaints handling to confirm that the branch practices and procedures comply with MFDA By-laws, Rules and Policies and other applicable securities legislation.

Members will be required to develop an appropriate branch review schedule and cycle. Branches must be prioritized by risk ranking. Members with a smaller number of branches and sub-branch locations are expected to perform a review of these locations annually. Where a Member has a significant number of branch and sub-branch locations and is able to justify a longer review cycle based upon their risk assessment, the review cycle can exceed one-year but should not in any event exceed three years.

The individuals responsible for completing the branch reviews must have the training, skills and proficiency necessary to accomplish the objectives of the review program. Individuals that have two years of relevant industry experience or that have successfully completed the courses required for designation as a branch manager as set out under MFDA Rules would generally be considered sufficiently qualified to perform branch reviews.

The Member must have as part of the branch review process a consistent means of tracking results; a means of reporting the results back to the branch in a timely fashion; a means of tracking responses; and a means of ensuring that the branch implements any required changes in a reasonable amount of time.

Branch review files, including working papers and other documentation, must be maintained in accordance with MFDA Rule 5 and must be made available to MFDA staff upon request.

C. Issues and Alternatives Considered

No other alternatives were considered.

D. Comparison with Similar Provisions

The Investment Dealers Association does not currently have a formal policy that prescribes particular standards for the implementation of a branch review program. On a more general level, IDA By-law 29.27(a) does require its members to establish and maintain a supervisory system that includes periodic on-site reviews of branch office supervision and requires proper records to be maintained with respect to such reviews.

NASD Rule 3010(c) prescribes standards regarding internal inspections by Members of branch offices to detect and prevent violations of applicable rules and legislation and to promote member compliance. The NASD rule specifies cycles for review of branch offices based on the type of supervisory activity carried on at the office. Under the rule, certain branch offices may require more frequent inspections where the risk ranking for the branch warrants. The rule requires that findings be recorded in a written report and kept on file by the member for a minimum of three years, or at least until the next inspection report has been written. Mandatory testing of certain basic supervisory procedures is required under the rule.

The proposed policy is consistent with existing MFDA Rules and Policies and with the requirements of other regulators as noted above.

E. Best Interests of the Capital Markets

The Board has determined that the implementation of the proposed policy is in the best interests of the capital markets.

F. Public Interest Objective

The proposed policy creates standards with respect to Member branch review procedures that are consistent with existing MFDA Rules and Policies. Furthermore, the proposed amendments will assist in the protection of the investing public by enhancing controls with respect to branch supervision and awareness of compliance policies at branch offices of Member firms.

III. COMMENTARY

A. Filing in Other Jurisdictions

The proposed Rule amendments will be filed for approval with the Alberta, British Columbia, Nova Scotia, and Ontario Securities Commissions and the Saskatchewan Financial Services Commission.

B. Effectiveness

The proposed Policy is simple and effective.

C. Process

The proposed Policy was developed by MFDA staff in response to comments received from Members and was reviewed by the MFDA Policy Advisory Committee. The proposed Policy has been approved by the MFDA Board of Directors.

D. Effective Date

The proposed Policy will be effective on a date to be subsequently determined by the MFDA.

IV. SOURCES

MFDA Rule 1.1.4
MFDA Rule 1.1.5
MFDA Rule 2.5.1
MFDA Rule 2.9
MFDA Policy 2
IDA By-law 29.27(a)

V. OSC REQUIREMENT TO PUBLISH FOR COMMENT

The MFDA is required to publish for comment the proposed Policy so that the issues referred to above may be considered by Ontario Securities Commission staff.

The MFDA has determined that the entry into force of the proposed Policy would be in the public interest and is not detrimental to the capital markets. Comments are sought on the proposed Policy. Comments should be made in writing. One copy of each comment letter should be

delivered within 30 days of the publication of this notice, addressed to the attention of the Corporate Secretary, Mutual Fund Dealers Association of Canada, 121 King St. West, Suite 1000, Toronto, Ontario, M5H 3T9 and one copy addressed to the attention of the Manager of Market Regulation, Ontario Securities Commission, 20 Queen Street West, 19th Floor, Box 55, Toronto, Ontario, M5H 3S8.

On request, the MFDA will make available all comments received during the comment period.

Questions may be referred to:

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MUTUAL FUND DEALERS ASSOCIATION OF CANADA

BRANCH REVIEW REQUIREMENTS [POLICY 5]

On September 14, 2005, the Board of Directors of the Mutual Fund Dealers Association of Canada made and enacted Policy 5, as follows:

INTRODUCTION

This Policy establishes minimum standards for the development and implementation of branch review procedures.

Members are responsible for establishing, implementing and maintaining policies and procedures to ensure that business is conducted and managed in accordance with MFDA By-laws, Rules and Policies and with applicable securities legislation. Under MFDA Policy 2, the Member is required to conduct an on-going review of sales compliance procedures and practices at both head office and at branch offices to confirm that these procedures are adequately fulfilling the purposes for which they have been designed. The requirement to complete regular branch reviews is consistent with these obligations and will serve to enhance the Member's ability to meet the fundamental supervision requirements under MFDA Rules.

The intent of this Policy is to establish minimum standards for internal branch review programs, while allowing Members sufficient flexibility to develop procedures that are appropriate to the Member's size and business model. Accordingly, strict adherence to the minimum standards as set out in this Policy will not necessarily ensure that a Member's branch review program is effective to ensure proper supervision and compliance with MFDA Rules. The objective is for Members to create and effectively implement processes that maximize their ability to detect potential compliance issues, so that corrective action may be taken before serious problems occur. MFDA staff will assess the effectiveness of the Member's branch review policy in the course of conducting compliance examinations and may impose additional requirements to ensure compliance with MFDA Rules.

BRANCH REVIEW POLICIES AND PROCEDURES

Each Member must establish procedures to effectively assess and monitor compliance with regulatory requirements at all branch and sub-branch locations.

a) *General Requirements*

- Branch reviews must include an assessment of the supervisory procedures and practices in place at the branch, as well as the quality of execution of those procedures.
- The branch review program must touch on all significant issues that are addressed in the Member's policy and

procedures manual and in the MFDA By-laws, Rules and Policies.

- The review process must include interviews with branch supervisors and other Approved Persons along with substantive testing to verify the accuracy of information that is provided in the interviews. Substantive testing should involve reviewing client files, trade blotters, trust account records, advertising and marketing material and other relevant records.

b) *Branch Interviews*

- The purpose of the interviews is to confirm that the branch manager and Approved Persons are aware of the requirements under MFDA Rules and other securities regulations. It is particularly important that the reviewer confirm that the branch manager has a good understanding of the fundamental supervisory requirements. The interview process also serves as a forum for the branch manager and Approved Persons to raise and discuss issues and areas of regulatory concern.
- The interviews must also include discussion about branch policies and procedures relating to:
 - products and services offered to clients;
 - complaints;
 - advertising and sales communications;
 - referral arrangements;
 - outside business activities;
 - account opening procedures; and
 - other branch and sub-branch supervision issues.

c) *Review of Trade Blotters and Other Supervisory Review Documentation*

- Documentation must be reviewed to confirm that trade reviews have been performed adequately and in a timely manner covering all trades in exempt securities and a sample of initial trades, leveraged transactions, trades made under a limited trading authorization or power of attorney, and trades in

speculative funds. Samples of different types of transactions, including purchases, switches and redemptions must be reviewed. Trade blotters must be reviewed to assess:

- trading patterns;
- evidence of supervision; and
- timeliness of review.

- The suitability of individual trades must be assessed to confirm that the quality of trade supervision is consistent with the Member's standards and regulatory expectations.
- Trade supervision records must also be reviewed to confirm the recording of issues noted by supervisory staff, inquiries made, responses received and resolutions achieved.

d) Review of Client Files

- Client files must be examined to verify that there is proper account opening documentation on file. Know-your-client information must be reviewed to:
 - assess completeness;
 - confirm that back up for any changes has been maintained on file;
 - confirm that branch client files are appropriately safeguarded; and
 - confirm that KYC information on the back office system matches with that recorded in the files.
- The review process must confirm that account opening approval procedures have been properly followed, where these are the responsibility of branch staff.
- Client files must be examined to verify that proper evidence of client instructions and any relevant trading authorizations have been maintained on file. Files should be reviewed to assess the adequacy of notes regarding advice or recommendations provided to the client, as well as notes regarding discussions relating to fees and services, if any.

- Trade orders must be reviewed to:
 - assess suitability;
 - detect unlicensed / out-of-province trading;
 - confirm proper identification of leveraged trades; and
 - confirm timeliness of trade processing.

e) Review of Client Communications

- The branch review program must include a review of client communications, including advertising, business cards, letterhead and websites to confirm that any required approvals have been obtained.
- The review process must also involve, where appropriate, discussions and testing to detect:
 - misleading communications;
 - undisclosed use of Approved Person trade names;
 - undisclosed outside business activities or personal financial dealings with clients;
 - securities related business conducted outside of the Member; and
 - undisclosed referral arrangements.
- Where the reviewer detects a potential material deficiency with respect to the conduct of outside business or personal financial dealings under MFDA By-laws, Rules or Policies, the branch review policy must provide that files of Approved Persons relating to non-Member business must be reviewed.

f) Complaints

- The review process must confirm that any complaints that may have been made involving individuals at the branch have been recorded and handled in accordance with Member procedures and MFDA By-laws, Rules and Policies.
- The nature of any complaints, as well as the timeliness and fairness of resolution must be assessed.

- The review process must confirm that all complaints and pending legal actions are made known to the compliance officer at head office (or another person at head office designated to receive such information) within two business days in accordance with MFDA Policy No. 3 (“Handling Client Complaints”).

SCOPE OF REVIEW

Sample size and the extent of the review are matters of discretion for the Member. However, at a minimum, the review should involve a preliminary screening of the branch that is sufficient to provide a reasonable indication of items or issues for further investigation. Sample size and the extent of review must be reasonable based on a number of factors such as the specific activities at the branch, complaints history, trade volume, commissions earned, results of previous reviews, MFDA compliance examination findings, daily trade supervision issues, the nature of dual occupations or outside business activities carried on at the branch, the volume of leveraged trades or the date of the last review.

SELECTION CRITERIA

The branch review policy must include criteria for selection and prioritization of the branches. This may be based on a number of factors such as complaints history, trade volume, commissions earned, results of previous reviews, MFDA compliance examination findings, daily trade supervision issues, the nature of dual occupations or outside business activities carried on at the branch, the volume of leveraged trades or the date of the last review. In any case, the Member must be able to demonstrate that there is a rational method for branch selection in place that is reasonable for the Member’s size and business model.

BRANCH REVIEW CYCLE

The Member must be able to justify its branch review schedule and cycle by developing a risk-based methodology to rank branch and sub-branch locations as high, medium or low risk using appropriate criteria. Such criteria would include: complaints history, trade volume, commissions earned, results of previous reviews, MFDA compliance examination findings, daily supervision issues, the nature of dual occupations or outside activities carried on at the branch or the volume of leveraged trades. Members with a smaller number of branches and sub-branch locations are expected to perform a review of these locations annually. Where a Member has a significant number of branch and sub-branch locations and is able to justify a longer review cycle based upon their risk assessment, the review cycle can exceed one-year but should not in any event exceed three years.

The branch review cycle and the status of completion of the branch review cycle against benchmarks should be included as part of the annual compliance report to the board of directors or partners of the Member required by MFDA Rule 2.5.2(b).

QUALIFICATIONS FOR REVIEWERS

The individuals responsible for completing the branch reviews must have the training, skills and proficiency necessary to accomplish the objectives of the review program. The individuals must possess sufficient knowledge not only to be able to follow prescribed procedures, but to be able to know where follow up review should be pursued. Individuals that have two years of relevant industry experience or that have successfully completed the courses required for designation as a branch manager as set out under MFDA Rule 1.2.2(a) would generally be considered sufficiently qualified to perform branch reviews. Relevant industry experience would include formal audit experience or legal training in the area of securities and mutual fund regulation.

The branch reviewer must be independent of the branch and the branch manager, so as to ensure that the reviewer can act objectively without preconceived opinions and is not subject to inappropriate influence when performing the review.

REPORTING OF RESULTS

All serious issues detected in the branch reviews must be made known to the compliance officer at head office (or another person at head office designated to receive such information) within a reasonable period of time.

Each Member must also ensure that branch managers and Approved Persons are made aware of all issues that are identified in the branch review in a timely manner.

The report to the branch manager on the results of the branch review must include the following information:

- the date of the review;
- basic branch information, including the Approved Persons and staff at the branch location;
- details of any compliance deficiencies noted in completing the branch review including missing documentation or any gaps in supervision;
- the date of the report; and
- the date by which a response is required.

FOLLOW UP OF BRANCH REVIEW FINDINGS

The Member must have in place processes to ensure that the issues identified in the course of the internal examination are followed up and resolved. Therefore, the branch review process must provide for:

- consistent and timely reporting of results;
- a means of tracking responses to the reports; and

- a means of ensuring that the branch implements all required changes in a reasonable amount of time.

BRANCH REVIEW FILES

Members must maintain orderly, up-to-date files for each branch that has been reviewed. The files must include details of the procedures performed at the branch and all working papers to support the work done and provide evidence of any deficiencies noted. All follow-up documentation, including the report to the branch manager, must also be included in the file. Records must be maintained for a period of seven years and must be made available for review by the MFDA, if requested.

Branch review records should be used to identify significant deficiencies that may disclose a need for further education and training of branch supervisors, Approved Persons, or other staff. When systemic issues are detected through the branch review process, a review of internal procedures and practices may be warranted.