

Chapter 13

SRO Notices and Disciplinary Proceedings

13.1.1 MFDA - Calculation of Risk Adjusted Capital (Rules 3.2.2, 3.2.5 and Form 1)

MFDA – CALCULATION OF RISK ADJUSTED CAPITAL (Rules 3.2.2, 3.2.5 and Form 1)

I. OVERVIEW

On June 29, 2006, the MFDA Board of Directors approved amendments to MFDA Rule 3.2 and the General Notes and Definitions of the MFDA Financial Questionnaire and Report (Form 1) (“MFDA FQR”) that relate to changes in the formula to be used by MFDA Members in calculating risk adjusted capital (“RAC”).

A. Current Rule

Under MFDA Rule 3.2.2, each Member is required to maintain capital in respect of its business in accordance with the requirements set out in MFDA Form 1. The formula for calculating regulatory capital uses a risk-adjusted working capital approach. The current formula limits current assets to those that are liquid and from reliable sources and deducts current liabilities, 10% of long-term debt and contingent liabilities, and margin items to arrive at RAC.

B. The Issues

The current formula is based upon a working capital approach and there may be situations where a Member has negative financial statement capital (equity plus subordinated debt), but sufficient working capital to comply with MFDA requirements. A Member could therefore be technically compliant with current MFDA capital requirements, but have liabilities greater than its assets.

MFDA staff has also identified issues with respect to certain Members that have long-term unsubordinated lending agreements with related parties. At present, Members are permitted to include the current portion of a related party loan plus an additional 10% of the long-term portion in calculating their capital position. Certain Members have drafted related party lending agreements that provide for minimal or no repayments over several years. This is done so that the Member avoids accruing a current liability, thereby minimizing the amount of capital required to be maintained. Further, MFDA staff has encountered situations where Members have made payments to related parties regardless of the fact that no payments were required under the terms of the lending agreement.

In addition, the current working capital approach does not guard against a long-term debt holder making requests for immediate or accelerated payments which may result in a Member having insufficient allowable assets to cover its current liabilities. Additional payments over and above those which are contemplated in existing lending agreements may be demanded by a creditor and the MFDA would only become apprised of the situation after the payment is made and, potentially, after a capital deficiency is created.

C. Objectives

The proposed Rule amendments were developed to:

- i) resolve the concern that a Member could be technically compliant with MFDA capital requirements, but have liabilities greater than its assets;
- ii) ensure that related parties will have their interests subordinated in the event of insolvency of a Member, or that the Member maintains sufficient allowable assets to cover any request for related party debt repayment;
- iii) require Members to notify the MFDA of any request for accelerated payments by creditors not contemplated under an existing repayment schedule.

D. Effect of Proposed Amendments

Under the proposed Rule amendments, Members will be required to maintain positive financial statement capital. Members will also be required to notify the MFDA of any request for accelerated payments by creditors not contemplated under an existing

repayment schedule. The notes and definitions to the MFDA FQR will require all related party debt to be considered a current liability unless a subordination agreement in the prescribed form is signed.

It is not expected that the proposed amendments will have significant effects on Members, other market participants, market structure or competition or that the proposed amendments will require Members to implement technological systems changes, or will result in significant additional costs for Members to comply with the proposed amended Rule.

II. DETAILED ANALYSIS

A. Relevant History

In 2005, when the MFDA Investor Protection Corporation began offering coverage, MFDA staff proposed to the Regulatory Issues Committee of the MFDA Board of Directors that the capital formula be changed to a "net free capital" approach which would have resulted in requiring all debt to be included in the formula. After receiving feedback regarding concerns with this approach, MFDA staff proposed an alternative of maintaining the current risk-based working capital formula, provided that certain Rule amendments be made to address issues with the existing regime. The options were considered and discussed by the MFDA Board of Directors and various committees of the Board.

On June 2, 2006 the MFDA Board met and decided to adopt MFDA staff's alternative approach of maintaining the existing formula, but making amendments to MFDA Rules and the MFDA FQR.

B. Proposed Amendments

The proposed amendments to Rule 3.2.2 will require that Members maintain total financial statement capital (or shareholders equity plus subordinated debt) greater than zero. This would resolve the concern that a Member could be technically compliant with MFDA requirements but have liabilities greater than its assets.

Under the proposed new Rule 3.2.5, Members will be required to notify the MFDA of any request for accelerated payments by creditors not contemplated under an existing repayment schedule. In order to allow MFDA staff to be more proactive in identifying and responding to capital concerns, notice of such requests or demands must be provided to the MFDA at the time the requests or demands are received by the Member.

The final proposed amendment involves a change to the notes and definitions to the MFDA FQR to require all related party debt to be considered a current liability unless a subordination agreement in the prescribed form is signed. As noted above, this is designed to address issues that have been identified relating to long-term lending agreements with related parties that are not considered subordinated debt. Related parties have significant influence over the repayment of such debt, which may be used for the purpose of manipulating the capital formula. The proposed amendment eliminates such potential abuses.

C. Issues and Alternatives Considered

The committee considered three possible approaches that could be adopted:

- (a) maintaining the status quo, which would involve no change to the existing formula;
- (b) adopting the net free capital approach, which would require that all debt be included in the capital formula; and
- (c) adopting the recommendations noted above.

It was agreed between MFDA staff and the members of the various Board committees that examined the issues that maintaining the status quo would not be an acceptable alternative. With respect to the other options considered, it was determined that a change to the net free capital approach would not be required as imposing this level of liquidity would be unnecessary and unduly onerous for the current mutual fund dealer business model.

After giving consideration to all of the options, it was resolved that the proposed amendments would enhance the existing capital regime and would be most appropriate given the nature of the business operations of the MFDA membership.

D. Comparison with Similar Provisions

The IDA approach requires that their member firms use the net free capital approach in calculating working capital. This approach was examined and rejected. The view of the MFDA is that it is not necessary to change the MFDA capital formula to a net free capital approach given the different business risks between IDA and MFDA Members. The positive equity approach would be more appropriate given the nature of the business operations of the MFDA membership.

E. Best Interests of the Capital Markets

The Board has determined that the proposed Rule amendments are in the best interests of the capital markets.

F. Public Interest Objective

The proposed amendments would enhance current standards in place to address potential investor protection concerns arising from Member insolvency. Further, the amendments will complement the ability of MFDA staff to accomplish the MFDA's regulatory mandate without undue interference in the business operations of the Members.

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 amendments are simple and effective.

C. Process

The proposed amendments were developed in response to concerns identified by MFDA staff. The proposed amendments have been approved by the MFDA Board of Directors.

D. Effective Date

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

IV. SOURCES

MFDA Rule 3.2.2
MFDA Rule 3.2.5
MFDA Form 1 – Financial Questionnaire and Report
IDA By-law 17
IDA Form 1 – Joint Regulatory Financial Questionnaire and Report

V. OSC REQUIREMENT TO PUBLISH FOR COMMENT

The MFDA is required to publish for comment the proposed amendments so that the issues referred to above may be considered by the Recognizing Regulators.

The MFDA has determined that the entry into force of the proposed amendments would be in the public interest and is not detrimental to the capital markets. Comments are sought on the proposed amendments. 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 Leslie Rose, Senior Legal Counsel, British Columbia Securities Commission, 701 West Georgia Street, P.O. Box 10142, Pacific Centre, Vancouver, British Columbia, V7Y 1L2.

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
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**MUTUAL FUND DEALERS ASSOCIATION OF CANADA
CALCULATION OF RISK ADJUSTED CAPITAL (Rule 3.2.2, 3.2.5 and Form 1)**

On June 29, 2006, the Board of Directors of the Mutual Fund Dealers Association of Canada made and enacted the following amendments to Rule 3.2:

3.2.2 Member Capital.

- (a) Each Member shall maintain capital in respect of its firm business in accordance with the requirements set out in Form 1.
- (b) Each Member shall at all times maintain positive total financial statement capital as calculated in accordance with the requirements set out in Form 1.

. . .

3.2.5 Notice Regarding Accelerated Payment of Long Term Debt. Each Member shall immediately notify the Corporation of any request or demand by a creditor for accelerated payments or any other payments in addition to those specified under the agreed regular repayment schedule with respect to contingent and long term liabilities owed by the Member.

On June 29, 2006, the Board of Directors of the Mutual Fund Dealers Association of Canada made and enacted the following amendment to the General Notes and Definitions section of the MFDA Financial Questionnaire and Report:

**MFDA FINANCIAL QUESTIONNAIRE AND REPORT
GENERAL NOTES AND DEFINITIONS**

. . .

11. For purposes of these statements and capital calculations, all related party debt must be recorded as a current liability unless a subordination agreement in a form satisfactory to the MFDA has been executed by the Member and other relevant parties in relation to such debt.