Mutual Fund Dealers Association of Canada
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July 22, 2004

Pat Chaukos
Senior Accountant /Legal Counsel
Compliance, Capital Markets
Ontario Securities Commission
20 Queen Street West
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Dear Ms. Chaukos:

Re: OSC Staff Notice 31-712 – Comment Letter

We are writing in response to your invitation to participate in the consultation process regarding the issues outlined in OSC Staff Notice 31-712 – Mutual Fund Dealer Business Arrangements. As a supplement to the information we have already provided in our earlier report to the OSC on the IDA/MFDA Joint Arrangement Project, we have provided responses to the specific questions raised in the Notice.

As a preliminary comment, we would like to re-state our position that we believe that joint arrangements should be allowed in principle, provided that they are properly structured. We acknowledge that there are certain arrangements presently in place that raise regulatory concerns, and appropriate action will have to be taken by the registrants that are party to these arrangements. However, in our view, the purpose behind regulatory policy is not to construct rules that will eliminate the potential for all problems to occur, but to strike a balance between investor protection needs and freedom in the market that will allow clients the ability to choose the products and services they want. We believe that such a balance can be achieved in this case. It may be that if we do not develop a structure to accommodate these arrangements, they may move "underground" subject to no ongoing oversight. The better course would be to define acceptable alternatives and actively monitor compliance with the relevant rules.

We would welcome the opportunity to participate in an open discussion on these issues and would encourage the OSC to make public the comments that are received in response to the Notice.

INDUSTRY TRENDS

Question 1
Do you agree with the description of current industry trends? Are you aware of any other similar changes?

We would agree with the general observation that as some clients become more sophisticated and knowledgeable about the market, they may look to diversify their investment portfolios by investing in equity and fixed income securities. In such cases, the options available to investors having only a mutual fund dealer account would be limited. In the interest of keeping their clients satisfied, mutual fund dealers may feel pressure to find ways to provide additional services. Joint servicing arrangements and omnibus accounts are strategies that have been employed to accomplish this.

However, from our investigation into the joint arrangements issue, of our 193 current member firms, we are aware of only 3 that are party to joint service arrangements and 13 that are involved in omnibus account arrangements. We did not find evidence that the issue of mutual fund salespersons acting outside their registration was prevalent or that there was any general intent on the part of dealers to circumvent proficiency requirements or registration limitations. Rather, the joint arrangements have typically been established to accommodate requests from clients that may arise out of a number of different situations. In many cases, the non-mutual fund securities in the client's portfolio are relatively small positions left in the account following transfers into a mutual fund dealer from an investment dealer. Often the client has no intention of actively trading on this portion of the portfolio. The joint arrangements are set up to hold the securities and facilitate trading when and if requested later. In virtually all cases, the activities make up a very small percentage of the registrant's business and generally there is little, if any, financial gain for the registrants that set up these accounts.

We have not found joint arrangements to be a significant source of investor protection problems and we are not aware of any complaints that have come out of such arrangements. Our suggestion would be to closely examine the scope of the issue before proceeding to impose broad restrictions. More precise information regarding the number of accounts, the types of securities and the frequency of trading is required to obtain a sense of the relative risk of harm to investors on this issue versus others, such as investment suitability.

Question 2
Are there other relevant business arrangements that have developed in response to these industry trends? If so, please describe.

To make a wider variety of services available to clients, a number of our Members enter into referral arrangements, including arrangements with non-SRO entities. These other parties include investment counsel / portfolio managers, financial institutions and other businesses. Referral arrangements are allowed under our Rules, provided that the other entity is adequately regulated; there is a formal agreement in place between the Member and the other entity; the Member has systems in place to account for payments made under the arrangement; and the client is provided with the required disclosure.

OMNIBUS ACCOUNTS

Question 3
How are clients being properly served when only a portion of the portfolio held by the mutual fund dealer can be serviced by the mutual fund dealer?

The answer to this question will depend to a large extent upon the circumstances and the expectations of the particular client. Clients have a right to decide where they will put their money and who they will deal with. There is no requirement for a client to hold assets at one dealer, or even that other assets be disclosed as part of the account opening / know your client process. Many retail clients have accounts with several dealers and there is no holistic management or advice regarding other accounts expected or provided. More complete information is generally provided to representatives providing financial planning advice, which will properly involve discussions related to all asset classes that the client holds or might hold. Regardless, the ability to advise a client with respect to many of these assets is limited by contract and other existing regulatory requirements, whether the individual is licensed through a MFDA firm or an IDA firm. Clients will often be referred elsewhere to purchase assets or receive additional advice to put the financial plan into effect. For example, a representative cannot advise on insurance needs without additional licensing.

Clearly, a client is not properly served where he or she is mislead as to the services that can be provided by a registrant. However, if full disclosure of the arrangements is made and the client understands what is being offered, the client should have the right to decide if the services are adequate for his or her purposes. The focus for regulators should be whether or not the salespersons/dealers are acting within the bounds of their registration and whether or not the client has been given an opportunity to make an informed choice. Joint arrangements are not unlike the discount broker model, in that as long as the client is informed about registration limitations and agrees, and the dealer and representative observe those limitations, there is no particular regulatory concern.

Question 4

What actions can be taken to ensure that the mutual fund dealer salesperson is acting within the terms of his/her registration regardless of client pressure?

We believe that proper monitoring of compliance with the limitations imposed under securities regulation and SRO Rules can be done through the implementation of preventative and detective controls. Detective controls include reporting of activity in these accounts and trend analyses with respect to volumes of activity by representative and volumes of particular securities. Preventative controls include order entry supervision and controls at the IDA firm that is party to the arrangement. The activities of the mutual fund salesperson must be supervised at both the branch and head office levels to ensure that the individual does not go beyond the limits of his/her registration.

Question 5

What actions, if any, are being taken by mutual fund dealers to ensure that clients are aware of the lack of coverage on assets held by the mutual fund dealers at investment dealers? What actions should be taken in this regard?

As noted in our report to the OSC, we found that proper disclosure to clients regarding the joint arrangements was lacking at many of the firms that were reviewed. We would support regulations requiring that mutual fund dealers disclose to clients any limitations that may exist with respect to investor protection coverage for assets held in omnibus accounts.

We would also like to voice our support for the application of similar disclosure requirements to other arrangements where trust companies hold client assets that are also not subject to investor protection coverage. We believe that there is no material difference between some of the joint arrangements described in the OSC's Notice and custodial arrangements that are presently in place with some trust companies. The disclosure requirements should be applied equally to both situations.

In any case, we will continue to work towards the implementation of investor protection coverage with respect to MFDA Members. This remains one of our primary objectives, regardless of any decision that is made with respect to the acceptance of joint service arrangements. Additionally, we may consider looking into the availability and related costs of obtaining specific insurance coverage to apply to joint arrangement situations.

Question 6
What controls or requirements could be put in place to ensure that mutual fund dealers are only trading and providing advice on mutual fund securities, while allowing clients to consolidate their holdings in one account?

We have discussed detective and preventative controls above. In addition, we believe that the current registration regime, along with requirements for clear contractual liability in the relationships, and mandatory disclosure/consent are sufficient to address the issues. Account opening documents and account statements should include disclosure of the fact that the mutual fund dealer and Approved Person cannot provide advice with respect to securities in the omnibus account; that the securities are not subject to CIPF coverage; and that transactions in non-mutual fund securities are not shown on the mutual fund dealer statement, as these are executed through the IDA Member.

Specific approval of the joint arrangements could be required from both the IDA and the MFDA as a precondition to allowing members to engage in such activities.

JOINT SERVICE ARRANGEMENTS

Question 7
Under our current regulatory framework, what actions, if any, can be taken to address concerns regarding supervision of salespersons in joint service arrangements? How can clear lines of responsibility of each of the dealers be maintained?

The possibility of allowing introducing/carrying dealer arrangements between MFDA and IDA dealers has been proposed. We believe that this is a viable option, and should continue to be explored. Under the introducer/carrier proposal, as under our existing Rule 1.1.6, the supervisory responsibilities and liability of both parties would be clearly spelled out in a formal contract governing the arrangement. Prescribed terms to be included in the agreement would be contained in parallel IDA and MFDA rules ensuring that each provides proper disclosure of all relevant issues and closely monitors compliance with applicable SRO rules and policies. The agreement would be subject to the prior approval of the SROs.

The jurisdiction of each of the SROs is established by contract between the SRO and its members, and can be broadened, if necessary, under the terms of approval of the joint arrangement. A formal information sharing arrangement between the MFDA and the IDA can be put in place to address any potential gaps in the contractual arrangements. This would eliminate any doubt about SRO access to records of the dealers involved in the transactions and define the policies and procedures to be followed regarding compliance monitoring and potential enforcement actions.

Under some of the joint arrangements we examined, where clients are only able to purchase securities that the mutual fund dealer is entitled to sell, a formal introducer/carrier agreement may not be required. Under these arrangements, in essence there is an outsourcing of the mutual fund dealer's back office function to address systems limitations. This can give rise to issues regarding the continued responsibility for accuracy of records and, again, to questions of SRO access to records at the service provider. However, these are fairly straightforward issues and can be solved through contractual provisions and specific rules that would apply to such service arrangements.

Question 8
How can we ensure that responsibility and liability of dealers in joint service arrangements to clients is clear?

Dealers would be required to disclose certain mandatory information to clients regarding the joint service arrangements. This would include a clear statement regarding the liability of all parties to the arrangement. In cases where the IDA member is viewed as a service provider to the mutual fund dealer, its liability would be by contract to the mutual fund dealer, but not with clients directly. Where both dealers are directly involved in trading activities for clients, such as under the introducer/carrier scenario, liability to clients would be set out in SRO rules, as well as the client contract and the contract between the dealers.

Question 9
What controls, if any, could be put in place to prevent client confusion?

Further to our response above, the required client disclosure materials would include a statement clearly differentiating the entities involved in the arrangements. This would include mandatory disclosure in the client contract to be provided upon account opening, along with subsequent disclosure in sales communications, client statements, etc.

Question 10
Can you suggest any alternative solutions that would address the supervisory, accountability and liability issues that arise when salespersons act on behalf of two dealers?

As above, these issues can be largely dealt with under an introducer/carrier arrangement which provides for mandatory contract and client disclosure language. For arrangements that have been created for the purpose of addressing systems issues, regulatory concerns can be answered through the servicing agreements.

Question 11

What changes, if any, would you support so as to allow the mutual fund salesperson to service the investment dealer account?

The limitations as to the "service" that could be provided under a joint arrangement would have to be properly defined. As under introducer/carrier rules presently in place, the responsibilities and liability of each of the parties to the arrangement can be resolved through prescribed contractual provisions and/or mandatory disclosure to clients. Potential conflicts of interest can be addressed through controls over financial incentives and appropriate supervision. In any event, the representatives and dealers involved on either side of these arrangements are all registrants, so there is no issue regarding the ability of the OSC to act against any of the parties for breach of the rules.

In addition, we also feel that changes to these regulatory requirements should be supported by allowing registrants to make appropriate systems changes. The suggestion has been made that consolidated back office systems could be allowed for related IDA/MFDA entities. IDA Member Regulation Notice MR-0291 sets out the conditions for approval of shared back office functions with respect to financial institutions aside from mutual fund dealers. We would submit that these provisions can be applied equally to mutual fund dealers, with the proper controls in place. In this way, issues relating to supervision of consolidated accounts would be simpler to resolve.

ALTERNATIVES CONSIDERED

Question 12

Referral arrangements require that clients have separate accounts at each dealer, instead of one consolidated account. The need for separate accounts may raise issues of convenience from the client's perspective; beyond this, are there any issues or consequences of referral arrangements that we should be aware of?

We are of the view that the issues behind the need for a consolidated account, such as foreign content, costs and the ability to preserve relationships, are more than simply matters of convenience. We would therefore stress the need to find a solution to achieve these goals, using either consolidated or separate accounts.

Question 13

- **If the MFDA/IDA introducer/carrier model contemplates two dealers servicing one client account, how can clear lines of responsibility (including supervision, accountability and liability) of each of the dealers be maintained?**

The answer here again lies with the proper definition of "servicing" and the assignment of responsibilities and liability under the formal contract governing the arrangement. We note that under IDA By-law 35, which has been in place for some time, dealers that are party to type 3 or type 4 introducer/carrier arrangements are allowed to provide full service on some securities related activities provided under the arrangements, while maintaining clear lines of responsibility.

We are concerned that there appears to be some scepticism as to the viability of the

introducing/carrying dealer model, even though it has yet to be developed. Our hope is that staff at the OSC approaches this issue with an open mind. The MFDA and the IDA are in the process of putting together a joint working group to further examine the introducer/carrier model in the context of joint arrangements. We will be reporting on the results of the group later this year.

- **Alternatively, if this introducer/carrier model contemplates two dealers servicing two client accounts, how does this meet clients' needs?**

Again, we do not believe that it is the place of the regulators to define structures that will or will not meet a particular client's needs. Though some clients are looking for one-stop shopping for financial services, others seek out diversification in the advice they receive and the institutions they deal with. Clients should be given the right to choose. As long as there is proper disclosure of the necessary elements of the arrangement and no party to the arrangement exceeds the limits of their registration, further regulatory involvement is not required.

- **Furthermore, what actions can be taken to ensure that the mutual fund dealer salesperson is acting within the terms of his/her registration?**

We believe that proper monitoring and enforcement of the existing regulatory requirements will be sufficient to address this requirement.

Question 14

Are you aware of any arrangements that would allow a mutual fund dealer to service its clients' needs for one consolidated account, yet do not raise these regulatory concerns?

As noted above, we believe that an introducer/carrier arrangement would potentially allow for consolidated accounts to be serviced by a mutual fund dealer.

Question 15

What are alternative solutions to the issues raised by the OSC with respect to joint service and omnibus account arrangements? Do these solutions require changes to the regulatory structure or requirements?

We believe that the suggestions provided above can provide a solution to the issues raised by the OSC and in fact many of the issues have already been addressed in current regulations. Clarification of our interpretation of the application of the rules may require some additional explanation, which can be provided through SRO bulletins and Member Regulation Notices. SRO rule changes may be needed to address any gaps.

Further, as mentioned above, whether or not an IDA/MFDA introducing and carrying dealer arrangement provides a workable solution, servicing arrangements may be useful to resolve the issues regarding some joint servicing models. As with the introducing/carrying proposal, these would be documented under formal written agreements and could be subject to the pre-approval of both SROs. The nature and extent of the liability of both parties can be specified according to prescribed terms, including the obligation to confirm that registration limitations are properly observed.

Another alternative is the trust structure, where trades are placed through MFDA and IDA dealers, but securities are transferred and held in a single custodial account at a trust company. Though this structure has been approved by regulators, many of the same criticisms that have been raised with respect to omnibus accounts would apply to these arrangements. As previously mentioned, investor protection plan coverage does not apply. In addition, unlike omnibus accounts, the custodial accounts are structured in a way that they are outside of the authority of the securities regulators. The Office of the Superintendent of Financial Institutions does not actively regulate the securities activities that are carried out under such arrangements. The extent of the issue is also much broader, as we are aware of approximately $24 billion currently held in these custodial accounts, compared to approximately $1 billion that our members hold in omnibus accounts. Though we appreciate that trust companies are subject to capital requirements under applicable regulations, we point out that mutual fund dealers are also subject to similar requirements, as tailored to the securities activities they are involved with.

Question 16

Does a restricted dealer registration category continue to be appropriate in the current business environment where clients want to have one consolidated account and be serviced by one sales representative?

There is a danger in identifying an apparent trend that some types of investors are seeking broader diversification of their investment portfolios and assuming that this will apply to the needs of all, or even a majority of investors. Many of our Members would argue that there is a large segment of the investing public that is satisfied that mutual fund investments are sufficient for their purposes and the rationale behind the creation of the limited registration category continues to apply in today's market. In fact, of the roughly 200 dealers that have joined the MFDA since 2001, only one small member employing four approved persons, has opted to move to the Investment Dealers Association. Though we have seen the same pattern of dealer consolidation that has occurred in other segments of the industry, we continue to receive applications from prospective new members. Under the existing system, mutual fund dealers continue to offer a level of service that meets the needs of their clients, at the same time subject to an appropriate level of investor protection controls. Indications are that the system is working well, and the fact that joint service and omnibus account arrangements have been put in place to service the needs of some clients does not justify fundamental changes to the structure of the industry.

By forcing all dealers to operate under the umbrella of the investment dealer model, dealers will face significant costs relating to systems enhancements that would have to be implemented to perform additional compliance and operational functions. Firms whose client base is made up of mutual fund investor accounts would be penalized, as they would be expected to have the functionality in place to serve other types of accounts beyond their target market. This may well lead to increased costs for the average mutual fund investor that does not require these services. Some mutual fund dealers may simply opt to serve their clients by selling insurance products or other products that are not regulated under securities legislation.

As we have suggested in our response to question 1, a detailed examination of the scope of the perceived problem and the relative harm resulting from such arrangements should be completed before proceeding with any large-scale overhaul of the existing system. It may be that regulatory

resources would be better utilized addressing other issues that present a greater risk to investors. We believe that in any case, the OSC should be addressing the issue of wholesale registration reform separately and on a national basis, rather than in the context of joint arrangements.

Question 17

If mutual fund dealers and investment dealers are required to unwind the joint service and omnibus account arrangements, what will the impact be to your firm's clients, as well as to your firm, and how long do you anticipate this would take?

We anticipate that the cost to unwind these arrangements will be a significant issue for dealers, and may well lead to added costs for clients. In some cases it may result in the termination of existing relationships between representatives and clients. Alternatively, to avoid severing relationships, some clients may choose to liquidate holdings, leading to the crystallization of losses or tax consequences where capital gains are realized. Other clients may be encouraged to enter into arrangements that are clearly inappropriate under securities regulation, but difficult to police.

We would be pleased to discuss our comments further with you and provide such further particulars as might be helpful to this consultative process.

Thank you for considering our remarks.

Yours truly,

Mutual Fund Dealers Association of Canada

Mark T. Gordon
Executive Vice-President