

**1.1.2 OSC Amendment to Staff Notice 31-712,
Mutual Fund Dealer Business Arrangements**

**ONTARIO SECURITIES COMMISSION
AMENDMENT TO STAFF NOTICE 31-712
MUTUAL FUND DEALER BUSINESS ARRANGEMENTS**

Introduction

This Staff Notice amends and replaces the OSC Staff Notice 31-712 published on June 11, 2004.

The Ontario Securities Commission (OSC) has reviewed certain business arrangements between mutual fund dealers and investment dealers that have evolved to enable clients of mutual fund dealers to have a broad range of security holdings in their accounts, including securities in which the mutual fund dealers are not registered to trade (Prohibited Securities). Accommodating clients' needs to hold all their securities in one account poses problems for mutual fund dealers since their registration limits the types of investments in which they can trade and for which they can provide advice. Our registration system recognizes that there are differing regulatory requirements that are applicable to restricted categories of registration. For example, the proficiency requirements for salespersons that are restricted to the sale of mutual fund products are lower than those required of a full service dealer; and the minimum capital requirements are generally lower for a mutual fund dealer. The following two business arrangements are not in compliance with current regulatory requirements and raise investor protection concerns:

1. Omnibus account arrangements – under these arrangements, a mutual fund dealer maintains an omnibus account in its name at an investment dealer to hold Prohibited Securities for its clients; and
2. Joint service arrangements – under these arrangements, a mutual fund dealer and an investment dealer jointly service a client who maintains an account at the investment dealer.

At the request of the OSC, the Mutual Fund Dealers Association of Canada (MFDA) and the Investment Dealers Association of Canada (IDA) issued a Joint Notice in June 2004 instructing their members not to enter into any new joint service or omnibus account arrangements, and not to accept new clients utilizing any existing arrangements. The OSC also considered requiring mutual fund dealers and investment dealers to unwind these arrangements. Since this could have a significant impact on clients, as well as industry participants, we were prepared to consider alternate solutions, if any, that would effectively address the regulatory and investor protection concerns that are raised by these arrangements.

To achieve this result through the most appropriate course of action, the OSC engaged the industry in a consultation process in the summer of 2004. As part of the consultation process, the OSC invited members of the MFDA and the IDA to comment on the Issues Paper *Mutual Fund Dealers*

Business Arrangements published in June 2004, to propose solutions to address the concerns, and to attend a roundtable meeting with a panel of Commissioners. A copy of the Issues Paper was also published for information purposes.

Industry Consultation

Over 20 comment letters were received from the industry, including MFDA members, IDA members, the Investment Funds Institute of Canada (IFIC), and the MFDA. Over 10 dealers, IFIC and the joint MFDA-IDA industry working group participated in the roundtable meeting. The written submissions and the oral submissions at the roundtable meeting were largely consistent. Copies of the comment letters and the Issues Paper are available on the OSC website at www.osc.gov.on.ca. The OSC would like to express its appreciation to the industry for their input in this matter.

Industry Trends

A number of comments were received regarding the industry trends, including:

- (a) Some commenters noted that clients do not have a preference for one-stop financial shopping nor do they need to consolidate all their financial assets into one account; they, however, prefer to have one individual overseeing their overall financial needs;
- (b) Other commenters noted that omnibus account arrangements were established to accommodate clients' needs to consolidate all their assets, including Prohibited Securities, at the mutual fund dealer;
- (c) The MFDA noted that only a limited number of its members are party to omnibus account arrangements and joint service arrangements;
- (d) Some commenters believe that joint service arrangements, in the form of a mutual fund dealer and investment dealer introducing/carrying arrangement, should be allowed if they are subject to certain controls or restrictions;
- (e) A number of commenters indicated that omnibus account arrangements and joint service arrangements should be prohibited; and
- (f) The mutual fund dealer registration category continues to be appropriate at this time, and addresses the needs of certain clients.

Proposed Solutions

The following solutions were proposed by the industry:

- (a) Referral arrangements;
- (b) MFDA/IDA introducing/carrying arrangements;
- (c) Back office servicing arrangements;
- (d) Trust company/financial intermediary model;
- (e) Restricted sales representatives at full-service firms; and
- (f) Enforcement of current requirements.

A number of dealers noted that they have chosen not to enter into omnibus account arrangements and joint service arrangements to ensure compliance with current regulatory requirements. These dealers found alternative solutions that are in compliance with current regulatory requirements to respond to their clients' needs. Two alternative solutions are as follows:

Referral Arrangements

Many commenters acknowledged that referral arrangements have been established by mutual fund dealers to address clients' needs to access different types of products and services. When clients of a mutual fund dealer want to purchase or otherwise trade in Prohibited Securities or other services that the mutual fund dealer cannot offer, the mutual fund dealer will refer the clients to other dealer(s) that have the appropriate expertise and proficiency. The requirement to maintain different accounts with different dealers also ensures that the responsibilities and liability of each dealer are separate and clear. It also ensures that clients will have the benefits of the applicable investor protection fund coverage should the need arise due to the failure of the dealer.

Existing Trust Company/Financial Intermediary Model

Under this model, responsibilities to service a client are clearly divided among a trust company, a mutual fund dealer and an investment dealer. The trust company acts as a trustee for the client's registered plan, and provides statements for the registered plan to the client. The mutual fund dealer and the investment dealer are each responsible for executing trades for and providing advice to the client in relation to those securities in which they are registered to trade. They are also responsible for issuing statements of account to the client on those transactions for which they are responsible. The trust company or the investment dealer is responsible for holding the securities in the registered plan.

Other Solutions

During the consultation process, many industry participants supported the mutual fund dealer and investment dealer introducing/carrying arrangement. However, this arrangement cannot be implemented until the MFDA becomes a sponsoring self-regulatory organization of the Canadian Investor Protection Fund, which will not be in the foreseeable future. Therefore, this is not a viable solution at this time.

Other solutions were also raised. The MFDA and IDA suggested back office servicing arrangements, which will allow mutual fund dealers to outsource their back office functions to affiliated investment dealers. The OSC understands that this solution only resolves the systems issues relating to joint service arrangements, and will only be available to affiliated dealers. Another alternative suggested during the consultation is to allow full-service investment dealers to hire restricted sales representatives. The OSC notes that this alternative might necessitate changes to existing registration provisions and will consider this as part of the Registration Project.

Next Steps

Based on the comments received and discussions with the industry, we have noted that a number of mutual fund dealers have chosen not to enter into omnibus account arrangements and joint service arrangements and are able to continue to service their clients using other business arrangements. For example, referral arrangements and the trust company/financial intermediary model can be utilized to address client needs without dealers being offside current regulatory requirements. The other proposed solutions cannot be implemented immediately and do not address all the investor protection concerns, e.g. pressure to act beyond the scope of registration, client confusion, unclear supervisory responsibilities and liability, and lack of protection fund coverage. In addition, only a limited number of mutual fund dealers utilize omnibus account and joint service arrangements.

As a result, the OSC has directed the MFDA and the IDA to enforce current regulatory requirements, i.e. mutual fund dealers and investment dealers must unwind existing omnibus account arrangements and joint service arrangements. Mutual fund dealers should not trade in, provide advice on or act in furtherance of trades in Prohibited Securities. Dealers should notify their clients of changes to the omnibus account and joint service arrangements, impact to their clients, and options available to minimize or eliminate any potential adverse consequences to their clients. In order to allow dealers time to implement these changes and to ensure that client interests are placed first, a transition period expiring October 31, 2005 will be provided. The OSC has also directed the MFDA and the IDA to monitor the progress of their members in unwinding these arrangements.

Questions

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