

**Oversight Review Report of
the Mutual Fund Dealers Association of Canada**

Issued: April 15, 2013

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I. Introduction

The Mutual Fund Dealers Association of Canada (MFDA) is recognized as a self-regulatory organization for mutual fund dealers by the Alberta Securities Commission, the British Columbia Securities Commission (BCSC), the Financial and Consumer Affairs Authority of Saskatchewan, the Manitoba Securities Commission, the New Brunswick Securities Commission, the Nova Scotia Securities Commission, and the Ontario Securities Commission, collectively, the Recognizing Regulators. The MFDA's head office is in Toronto and regional offices are in Calgary and Vancouver.

The MFDA is not recognized as a self-regulatory organization in Québec. However, the MFDA cooperates with the Autorité des marchés financiers (AMF) concerning the regulation of MFDA member firms with operations and activities in Québec and elsewhere.

This report details the objectives, methodology, report format, scope, and findings of the oversight review completed by the Recognizing Regulators for the review period from January 1, 2009 to June 30, 2012.

1. Objectives

The objectives of the oversight review were to:

- assess whether the MFDA was in compliance with the terms and conditions (T&C) of its recognition orders (ROs)
- determine whether the MFDA's regulatory processes were efficient, effective, consistent, and fair
- evaluate whether the MFDA had adequate staffing, resources, and training to effectively and efficiently perform its regulatory functions

2. Methodology

The Recognizing Regulators adopted a new, risk-based methodology for this review. The Recognizing Regulators:

- assessed the inherent risks of each functional area of the MFDA based on discussions with senior MFDA personnel; reviews of internal MFDA documentation including annual management self-assessments; and information received from the MFDA in the ordinary course of oversight activities
- evaluated known control functions for each area
- considered relevant situational/external factors such as market conditions and changes in legislation
- calculated an overall risk score for each area
- used the risk score to determine the scope and depth of the review

3. Report format

Previously, Recognizing Regulator staff (Staff) produced reports that detailed both effective and ineffective processes of the MFDA. In keeping with a risk-based approach,

this report focuses on those areas with findings and includes general commentary on the areas within the scope of the review.

4. Scope

Staff determined through a risk assessment that the following are low risk areas that did not require review:

- Financial viability and fees - Staff monitored the MFDA's financial position through reviews of its financial statements and budgets on an ongoing basis.
- Business continuity plan (BCP) - Staff evaluated the BCP as part of the previous oversight review and noted no issues. The MFDA updates its BCP annually and there were no significant changes to the organizational structure since the last oversight review.
- Cooperative Agreement in Québec - The AMF and the MFDA confirmed that the MFDA complied with the terms of the cooperative agreement concerning the regulation of MFDA member firms with operations and activities in Québec and elsewhere.

The oversight review covered the following areas:

- Corporate Governance
- Sales Compliance
- Financial Compliance
- Enforcement
- Policy
- Membership

Staff identified and assessed the key processes for each of the areas covered in the review. The scope of the review included only those processes or components that Staff assessed to be higher risk in each of the areas.

5. Overall assessment

Based on the risk assessment, the scope of the work performed, and the results of the review, Staff are satisfied that the MFDA met the terms and conditions of the ROs in the areas covered during the review period. Nevertheless, Staff identified areas for improvement that require the MFDA to take corrective action. These are set out in the *Fieldwork, findings, and recommendations* section. In addition, Staff set out observations and suggestions for improvement for the MFDA to consider in Appendix A.

6. Finding prioritization and functional assessment scale

Staff prioritized all findings into high, medium, and low, based on the following criteria:

High The issue is significant or is a somewhat significant repeat finding. The MFDA should take corrective action immediately and regularly report on its progress.

Medium The issue is moderately significant. The MFDA should resolve the issue within a reasonable timeframe and report on its progress.

Low The issue is not significant. Staff discussed it with MFDA management for their review and consideration.

Staff assessed the functional areas using the following scale:

Staff are generally satisfied with the processes and/or policies reviewed in this area.

Staff are generally satisfied with the processes and/or policies reviewed in this area, but noted some that require improvement.

Staff found significant weaknesses with the processes and/or policies reviewed in this area that require urgent corrective action.

II. Fieldwork, findings, and recommendations

A. Corporate Governance

T&C #3 of the RO requires that the MFDA's Board of Directors secure a proper balance between the interests of the different members of the MFDA in order to ensure diversity of representation on the Board. In recognition that the protection of the public interest is a primary goal of the MFDA, a reasonable number and proportion of directors on the Board and on the committees of the Board shall be and remain during their term of office Public Directors as defined in the MFDA by-law.

Staff focused their review on the findings of the 2009 oversight review and the 2011 BCSC decision regarding governance and proxy solicitation at the MFDA. Staff reviewed the report of the governance task force established by the MFDA and the steps taken by the MFDA to address the issues raised in the decision. Staff also reviewed documentation relating to the:

- procedures for proxy solicitation
- procedures for selecting and nominating board members
- Annual General Meetings
- board committee work plans
- board committee Terms of Reference
- agendas and minutes of the Board of Directors and board committee meetings including those of the Governance Committee
- MFDA Directors Manual and Directors Handbook

Staff interviewed the Chair of the Board and Chair of the Governance Committee, a member of the Board of Directors and the Governance Committee, and the Corporate Secretary.

Staff found that the MFDA adopted policies and procedures that address the issues raised in the BCSC decision and otherwise complied with the terms of the RO.

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| Assessment | Staff are generally satisfied with the processes and/or policies reviewed in this area. |
| Findings None | |

B. Sales Compliance

T&C #7 of the RO requires the MFDA to conduct periodic examinations of its members and Approved Persons (APs) to ensure their compliance with MFDA rules.

The primary responsibility of the MFDA's Sales Compliance department is to perform on-site sales and business conduct examination of members. In 2012, Sales Compliance adopted a new risk-based approach for selecting members to examine. Previously, Sales Compliance reviewed all members once every three years. Under the new approach, the MFDA will examine members once every two or four years depending on the risk rating of the member.

A primary objective of this part of the oversight review was to evaluate the new selection process, including whether the process appropriately identified higher risk members for more frequent reviews.

Staff also focused on:

- adequacy of the compliance examination process, including the timely completion of examinations and closing of files after report issuance
- concerns raised in the previous oversight review about the extent of branch office reviews conducted in the Maritimes region
- quality of the compliance examinations performed by MFDA staff, including whether MFDA compliance staff followed new procedures for referring files to enforcement
- concerns raised in the previous oversight review about the adequacy of follow up procedures on members' BCP

Staff interviewed the Vice-President of Compliance and the Director of Sales Compliance in addition to individual Sales Compliance Managers and staff. Staff reviewed the policies and procedures used by Sales Compliance staff, including the Sales Compliance Risk Model, Sales Compliance Examination Program, the Compliance Officer Manual and the Sales Compliance examination schedules. To assess the quality of examinations performed, Staff reviewed a sample of 30 compliance examination files including examinations of head and branch offices.

Staff found that the MFDA's new member selection process is adequate and considers risk factors such as sales practices that include leveraging and exempt products in addition to know your client considerations. Staff were generally satisfied with the examination process with the exception of the finding below. MFDA staff adequately followed the examination program and documented files to support the findings in reports to members. Staff were also satisfied with the procedures the MFDA put in place to address the BCP finding from the previous oversight review.

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| Assessment | Staff are generally satisfied with the processes and/or policies reviewed in this area, but noted some that require |
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| | improvement. |
| Findings | |
| <p><u>Follow-up on deficiencies with unresponsive or uncooperative members</u> Staff identified a few instances where members were unresponsive or uncooperative when dealing with deficiencies identified during the examination process. In cases that do not warrant enforcement action, the MFDA lacks the necessary regulatory tools to adequately deal with these members.</p> | |
| Risk Implication | Members that are unable or unwilling to address deficiencies in a timely manner, create increased overall risk for investors. |
| Recommendation | The MFDA should develop processes and implement regulatory tools to ensure compliance by unresponsive or uncooperative members. |
| Priority | Medium |
| MFDA's Response | <p><i>With respect to the few instances noted in the finding, the Members provided MFDA staff with responses to the examination findings and MFDA staff promptly followed up on the issues. In certain cases, MFDA staff also performed a subsequent targeted examination of the Member in order to test resolution.</i></p> <p><i>We agree that timely resolution of examination deficiencies is important. Accordingly, we have implemented a number of initiatives in recent years that have resulted in expediting resolution of examination findings.</i></p> <p><i>As a further initiative, the MFDA undertook a benchmarking analysis and reviewed the regulatory tools used by other securities regulators to promote timely resolution of examination findings. Unlike other securities regulators, the MFDA is unable to address resolution of certain deficiencies through a registration function as the MFDA was not delegated this authority under its various provincial recognition orders. However, consistent with the practice of other securities regulators, the MFDA will consider developing a process to charge fees to Members that require excessive attention to resolve examination deficiencies.</i></p> |

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| Staff Comments and Follow-up | Staff are satisfied with the MFDA's response and ask that the MFDA provide confirmation once the new process is implemented. |
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C. Financial Compliance

T&C #7 of the RO requires the MFDA to conduct periodic examination of its members and APs to ensure their compliance with MFDA rules.

In order to ensure member compliance with prudential requirements, the MFDA's Financial Compliance staff:

- review member financial filings to ensure that members maintain and report adequate capital in accordance with MFDA Rules
- conduct on-site financial compliance examinations of members
- review working paper files of the members' auditors

An important objective of this part of the oversight review was to evaluate whether the MFDA had adequate resources and qualified staff to perform financial compliance reviews, particularly for Level 2 and 3 members¹.

Staff also focused on:

- adoption of International Financial Reporting Standards in the examination program procedures and compliance with executing these procedures in the examination program
- processes for resolving financial compliance issues with the member or, where necessary, the referral of such matters to Enforcement
- concerns raised in the previous oversight review about performance benchmarks used by Financial Compliance staff, including benchmarks for reviewing audit working papers
- timeliness and quality of on-site financial compliance examinations and in office desk reviews of members' filings
- changes to the examination program, in particular, relating to the areas of trust accounting and segregating client cash that resulted from amendments to MFDA rules on segregating client property

Staff interviewed the Vice-President of Compliance and the Director of Financial Compliance. Staff reviewed policies and procedures including the Financial Compliance Program for examinations and desk reviews, and the Compliance Officer Manual. To assess the quality of financial compliance examinations, Staff reviewed a sample of 19 Financial Compliance examination files of Level 2 and 3 members, 17 Financial Compliance examination files of Level 4 members², and 39 Financial Questionnaires and Reports.

¹ Level 2 member dealers do not hold client cash, securities, or other property. They do not operate a trust account and they conduct business in client name only. Level 3 member dealers do not hold client securities or other property except client cash in a trust account.

² Level 4 member dealers may hold client securities or other property in nominee name accounts or in physical storage.

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| <p>Staff found that MFDA staff reviewed files in a timely manner and met the benchmarks relating to timing. While the majority of files were well documented, Staff noted that the documentation could be improved. Staff were satisfied that MFDA staff adequately followed the examination program and obtained and retained appropriate supporting documentation in the file. With one exception noted below, Staff were satisfied that the MFDA had appropriately resolved the Auditors' Working Papers findings from the prior oversight review.</p> | |
| Assessment | <p>Staff are generally satisfied with the processes and/or policies reviewed in this area, but noted some that require improvement.</p> |
| <p>Findings</p> <p>1. Review of Level 2 and 3 Financial Compliance examination files (see below)</p> <p>2. Benchmark for Auditors' Working Papers review (see below)</p> <p>There were also low-priority Financial Compliance findings (see Appendix A).</p> | |

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| <p><u>1. Review of Level 2 and 3 Financial Compliance examination files</u></p> <p>In one of the MFDA regional offices, there was no evidence that appropriately qualified personnel reviewed Level 2 and 3 member Financial Compliance examination files.</p> | |
| Risk Implication | <p>Financial Compliance files that are not reviewed by appropriately qualified personnel may increase the risk of undetected misstatements in the financial reports of Level 2 and 3 members.</p> |
| Recommendation | <p>The MFDA should maintain evidence of detailed review by appropriately qualified personnel in the Financial Compliance examination files of Level 2 and 3 members.</p> |
| Priority | <p>Medium</p> |
| MFDA's Response | <p><i>In all instances the files were reviewed by appropriately qualified staff. MFDA staff will ensure that they maintain evidence of the review by appropriately qualified staff.</i></p> |
| Staff Comments and Follow-up | <p>Staff are satisfied with the MFDA's response.</p> |

2. Benchmark for Auditors' Working Papers review

MFDA Rule 3.6 sets out the audit requirements that a member's auditor must comply with in order to support the opinions that they are required to express in the member's auditor report of Parts I and II of Form 1 Financial Questionnaire and Reports.

The 2009 oversight review noted that although the MFDA started to review Auditors' Working Papers in 2006, there were no benchmarks for either the number of Auditors' Working Papers to be reviewed or the length of time to communicate the findings of the review to the members' auditors. As a result, Staff recommended that the MFDA establish benchmarks in this area.

As of the 2012 oversight review, the benchmark relating to communicating findings to the members' auditors had not been established.

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| Risk Implication | The review of Auditors' Working Papers is necessary to ensure a member's auditor understands and complies with MFDA rules. In addition, timely feedback to a member's auditor will maintain or improve the audit quality of their future work as it relates to MFDA member firms. |
| Recommendation | The MFDA should establish appropriate benchmarks for communicating findings to the members' auditors relating to Auditors' Working Paper review. |
| Priority | Medium |
| MFDA's Response | <i>We acknowledge that we did not formally document the benchmarks for issuing findings to Member auditors. To address Canadian Securities Administrators (CSA) staff concerns, we immediately amended our policies and procedures to formally establish the benchmark.</i> |
| Staff Comments and Follow-up | Staff are satisfied with the MFDA's response. |

D. Enforcement

T&C #8 of the RO requires that the MFDA appropriately discipline its members and their APs who violate the rules of the MFDA and cooperate with the Recognizing Regulator(s) in the enforcement of applicable securities legislation. The MFDA Enforcement Department is responsible for enforcing compliance by its members and their APs with its rules.

The primary objective of this part of the oversight review was to evaluate whether Enforcement functions were conducted in an effective and efficient manner. Staff focused on the:

- performance benchmarks and sub-benchmarks used by Enforcement staff and assessed whether MFDA staff met them
- new procedures in Case Assessment and Investigation implemented since the last oversight review
- communication between Enforcement staff and other MFDA departments to assess referral processes
- quality and timeliness of MFDA enforcement files, including whether MFDA staff followed appropriate case screening procedures, whether MFDA staff prioritized and completed cases in a timely manner, and whether the disposition of cases was reasonable and supported by documentation in the file

Staff also followed up on a recommendation from the 2009 oversight review to determine whether the MFDA had implemented a more comprehensive procedure for file and documents management.

Staff interviewed the Vice-President of Enforcement, Enforcement managers, and other Enforcement staff. Staff reviewed the MFDA's Enforcement policies and procedures. To assess the quality of Enforcement files, Staff reviewed a sample of 77 enforcement files, including 53 case assessment files, 17 investigation files, and 7 litigation files.

Staff found that the files were well documented and completed in a timely manner and within the benchmarks. Staff were generally satisfied with the analysis of the issues and that the evidence gathered were sufficient and appropriate to support the disposition of the case. The Enforcement Department's internal procedures were adequate and followed by MFDA staff.

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| Assessment | Staff are generally satisfied with the processes and/or policies reviewed in this area. |
| Findings | None |

E. Policy

T&C #10 of the RO requires that the MFDA establish by-laws, rules, regulations, policies, forms, and other similar instruments necessary or appropriate to govern and regulate all aspects of its business and affairs. The Policy Department is responsible for:

- policy initiatives that address regulatory issues
- rule interpretation through Member Regulation Notices (Notice)

The primary objective of this part of the oversight review was to assess whether MFDA members' right to vote on rule proposals, under MFDA By-law No. 1, had any impact on the effectiveness of the MFDA's policymaking process.

Staff also focused on a BCSC hearing and review of a 2009 MFDA hearing panel decision. The BCSC hearing panel found that language in a Notice about churning was inconsistent with the guidance only role of Notices. Staff reviewed whether the MFDA addressed the concerns raised by the BCSC.

Staff interviewed the MFDA's General Counsel and Vice-President of Policy, and other senior management. Staff reviewed:

- Policy Advisory Committee, Regulatory Issues Committee, and Board of Directors minutes and materials
- Member Regulation Forum materials
- Annual General Meeting materials
- sample of three policy files
- other policy-related documents

Staff found no evidence that members' ability to vote on rule proposals compromised the effectiveness of the MFDA's policymaking process. Staff found that the Policy Department's policymaking process is generally adequate. Staff noted that Policy staff consulted regularly and appropriately with its policy committees and members. The Policy Advisory Committee appeared to consider adequately and objectively regulatory instruments that the MFDA presented to them. MFDA staff also appeared to take into account comments from committees and members, and revised proposals, when appropriate, based on those comments.

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| Assessment | Staff are generally satisfied with the processes and/or policies reviewed in this area, but noted some that require improvement. |
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Findings

Clarity in the regulatory implications of Member Regulation Notices

The MFDA recognized the concern raised in the BCSC decision, and took steps to clarify the regulatory effect of Notices prior to this oversight review, including:

- enhancement of the MFDA website by adding a description of MFDA regulatory instruments and their regulatory effect
- presentation on the regulatory effect of MFDA policy instruments at the Spring 2012 Member Regulation Forum
- presentation at the 2012 Annual Staff Training
- training of Regional Council Hearing Panel

The MFDA is also undertaking a Policy Instrument Review Project that will, when completed, clarify the regulatory intent of Notices. Staff recognize that MFDA staff have taken steps to address the concerns raised and note that this project will provide a more complete solution. Staff will monitor the progress of this project.

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| Risk Implication | If the regulatory effect of Notices is unclear, the Notices are less effective and enforcing the rules may be more problematic. |
| Recommendation | The MFDA should continue to clarify the regulatory status of Notices, and develop and implement processes to ensure that Notices do not contain language that might be interpreted or applied as rules. |
| Priority | Medium |
| MFDA's Response | <i>The MFDA will continue to take steps to ensure that the regulatory effect of Notices is clear.</i> |
| Staff Comments and Follow-up | Staff are satisfied with the MFDA's response. |

F. Membership

T&C #6 of the RO requires that MFDA rules permit all properly registered mutual fund dealers who satisfy the membership criteria to become members. The criteria and processes for approving or denying membership must be fair, consistent, and reasonable. The Membership Services Department is responsible for reviewing and approving membership requests, member reorganizations, membership resignations, and membership suspensions or terminations for disciplinary reasons.

The objective of this part of the oversight review was to determine whether the MFDA has fair and consistent processes for reviewing and approving membership applications and requests for member resignations and reorganizations, and for membership suspensions and terminations.

Staff assessed whether the MFDA obtained and reviewed all the relevant facts necessary to support membership decisions and the analysis performed by the MFDA to determine whether the decisions were properly supported. Staff considered the fairness and reasonability of terms and conditions imposed on applicants. Staff also verified that MFDA staff followed adequate internal policies and procedures to ensure the protection of client assets transferred because of member resignations or reorganizations.

Staff interviewed the Vice-President of Compliance, the Director of Financial Compliance, the Director of Membership Services, and other MFDA managers and staff to assess the adequacy of MFDA Membership Services' internal procedures. Staff also reviewed a sample of five member reorganization files and two membership suspensions and terminations.

Staff found that the MFDA's policies and procedures for reviewing and approving requests for membership, membership resignations, and member reorganizations are adequate and were adhered to by MFDA staff during the review period. The policies and procedures for membership suspensions or terminations for disciplinary reasons were adequate.

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| Assessment | Staff are generally satisfied with the processes and/or policies reviewed in this area. |
| Findings | |
| None | |

G. Miscellaneous

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| Technology | |
| <p>MFDA staff use a variety of mobile technologies, including laptops and Universal Serial Bus (USB) drives, in their work. MFDA staff take laptops to member premises and use USB drives to transfer files to and from member computers during the course of examinations and other regulatory activities.</p> | |
| Assessment | Staff are generally satisfied with the processes and/or policies reviewed in this area, but noted some that require improvement. |
| Findings | |
| <p><u>Data security with MFDA mobile technology</u> The MFDA provides USB drives to MFDA staff but does not password-protect or encrypt the contents. This raises a potential issue about information security.</p> | |
| Risk Implication | Use of unprotected mobile technology increases the risk of unauthorized access resulting in potential compromise of confidential MFDA and member information. |
| Recommendation | The MFDA should develop and implement a comprehensive policy respecting mobile technologies, including the password-protection or encryption of all mobile devices used by MFDA staff. |
| Priority | Medium |
| MFDA's Response | <i>MFDA staff immediately implemented the use of encrypted USB keys and provided CSA staff with its policies and procedures regarding USB keys during the review. All other mobile devices are subject to password protection and/or encryption.</i> |
| Staff Comments and Follow-up | Staff are satisfied with the MFDA's response. |

III. Appendix A – Low-priority findings and recommendations

| Functional Area | Staff Findings | Staff Recommendations | MFDA’s Response | Staff Comments |
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| Financial Compliance | <p><u>Quality and consistency of working paper documentation</u> Staff noted instances where documentation could be improved:</p> <ul style="list-style-type: none"> • There were inconsistent working paper documentation in 2 of 19 Level 2 and 3 examination files reviewed. Staff noted that the adjustments in the Form 1 Financial Questionnaire and Reports Adjustment Summary and the Risk Adjusted Capital (RAC) Adjustment Summary were not consistent with the adjustments in the examination program or the deficiency forms in the file. However, all adjustments in the final report to the member were supported by the tests of details and the analytic procedures in the file. • There was a lack of supporting documentation in 1 of 19 Level 2 and 3 examination files reviewed. In that file, a RAC adjustment, in the deficiency form and the RAC Adjustment Summary, was not supported by tests of details and analytic procedures. The adjustment in the file was accurate, but due to clerical | <ul style="list-style-type: none"> • The MFDA should ensure the adjustments in the Adjustment Summaries are consistent with the other working papers in the file to reduce the risk of inaccurately or incompletely reporting deficiencies in the final report to the member. • The MFDA should check the adjustments in the Adjustment Summaries and deficiency forms for accuracy as part of the manager review of each file prior to finalizing | <p><i>With respect to the first two findings, the MFDA has the recommended procedures in place to review working papers for accuracy.</i></p> <p><i>With respect to the third finding, while we believe that in the particular case noted there was sufficient information in the file to re-perform the test procedures, going forward we will ensure that the documentation standards are adhered to and consistently applied.</i></p> | <p>Staff are satisfied with the MFDA’s response.</p> |

| Functional Area | Staff Findings | Staff Recommendations | MFDA's Response | Staff Comments |
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| | <p>error, an incorrect amount was recorded on the RAC Adjustment Summary and deficiency form, and subsequently cited in the report to the member.</p> <ul style="list-style-type: none"> • Not all documentation standards outlined in the MFDA Compliance Officer Reference Manual were met in 1 of 19 Level 2 and 3 Financial Compliance examination files reviewed. In that file, not all working papers contained adequate referencing and information necessary to re-perform the executed procedures. | <p>the file to ensure that the working paper file records all RAC adjustments as accurate and complete, and that the final report to the member accurately reflects the findings.</p> <ul style="list-style-type: none"> • The MFDA should ensure that their documentation standards are adhered to and consistently applied in all Level 2 and 3 Financial Compliance examination files. | | |