



Mutual Fund Dealers Association of Canada
Association canadienne des courtiers de fonds mutuels
121 King Street West, Suite 1000, Toronto, Ontario, M5H 3T9
TEL: 416-361-6332 FAX: 416-943-1218 WEBSITE: www.mfda.ca

January 10, 2006

Task Force to Modernize Securities Legislation in Canada
Suite 1600
121 King Street West
Toronto, ON
M5H 3T9

Attn.: Thomas Allen, Q.C.

Dear Mr. Allen:

Re: Invitation to Comment

The Mutual Fund Dealers Association of Canada ("MFDA") is the national self-regulatory organization ("SRO") for the distribution side of the mutual fund industry. We are writing further to your Invitation for Comment dated September 16, 2005 inviting submissions to the Task Force to Modernize Securities Legislation in Canada (the "Task Force") on issues the Task Force will be examining.

The concerns that we raise below focus on the current regulatory approach to fund managers, the exempt market and the regulation of investment **counsel/portfolio** managers ("IC/PMs"). In particular, we are concerned with the regulatory gap and resulting investor protection risk that currently exists with respect to certain market participants, such as fund managers, that are not subject to any active regulatory oversight, but have a significant involvement in handling billions of dollars of client funds.

1. Fund Managers

a) Regulation of Fund Managers

Fund managers play an important role in the investment industry in the organization, management and administration of mutual funds. Some fund managers retain responsibility for all of the activities involved in the operation of a mutual fund, while others sub-delegate many responsibilities to other service providers. Fund managers that engage in trading in fund securities (acting as dealers), or managing the assets of the fund (acting as portfolio managers) require registration under provincial securities legislation. Fund managers that choose to delegate these functions to other service providers will typically not be registered and, accordingly are not subject to the same level of regulation by the securities commissions or **SROs**. In most jurisdictions there is a general standard of care imposed on the fund manager under provincial securities legislation. However, unregistered fund managers are not required to meet any specific requirements with respect to minimum regulatory capital, insurance or bonding

coverage, adequacy of management resources, competency and proficiency of staff or adequacy of internal systems, controls and procedures.

b) Recommendations

MFDA staff are of the view that greater oversight over fund managers is necessary to ensure that fund managers properly discharge their responsibilities in the operation of the funds they offer. In particular, we take the position that fund managers should be required to be registered with the securities commissions.

While registration requirements go part way in enhancing investor protection, active regulatory oversight of fund managers is also necessary. Such oversight should include on-site compliance reviews coupled with enforcement action where appropriate. Regulatory standards must be created to ensure that fund managers have the resources to carry out their functions and that investors have an avenue for recourse when they fail to do so. These standards would include requirements for minimum capital, insurance and bonding requirements, competency and proficiency of staff and adequacy of internal systems, controls and procedures.

Finally, there is a need for an investor protection fund similar to the MFDA Investor Protection Corporation and the Canadian Investor Protection Fund for client assets in the custody or control of the fund manager. In this way, client assets will be afforded much greater protection in the event that a fund manager insolvency results in a loss of client assets.

2. Exempt Market Distributors

With respect to the sale of exempt securities, MFDA staff have identified regulatory concerns regarding the inconsistent approach to the regulation of the exempt market generally and, more specifically, the differential treatment of registrants and non-registrants and SRO members and non-SRO members.

a) Regulation of Exempt Market Distributors in Canada

Among the Canadian jurisdictions, different requirements are placed on different types of registrants and products in the exempt market. Some provincial regulators require notice of a registrant's intent to sell exempt products while others require specific approval for each offering of exempt securities. Ontario and Newfoundland require Limited Market Dealer ("LMD) registration to transact in exempt securities. British Columbia imposes certain requirements on limited dealers that trade securities to their clients under registration and prospectus exemptions. The current disparate regulatory approach to exempt product distribution has created confusion for the investing public as well as for market participants.

b) Regulation of Mutual Fund Dealers' Exempt Market Activities Versus Regulation of Other Distributors of Exempt Securities

Another issue that must be addressed is the difference in oversight and regulation between registrants and non-registrants and SRO and non-SRO distributors in the exempt market. The

exempt market continues to grow as promoters, issuers and their representatives, many of whom are not required to be registered with a securities commission outside of Ontario and Newfoundland, become more familiar with the de-regulated nature of sales to "accredited investors" and others. In Ontario, there are approximately 600 limited market dealers ("LMDs") engaged in the business of selling exempt securities. Only those LMDs that are also registered as mutual fund dealers and are members of the MFDA are subject to active regulation through on-site compliance reviews.*

The MFDA regulates all the securities related activities of its Members, including the sale of exempt securities. MFDA Rules prohibit mutual fund salespersons from personally engaging in the sale of securities, including exempt securities, outside of their Member. The sale of exempt securities is subject to Member oversight and supervision requirements, which includes daily review by the Member of all trades in exempt securities. In conducting compliance reviews, MFDA staff review the exempt market activities of our Members in light of the MFDA business conduct rules, with specific focus on suitability issues, given the added concerns regarding risks associated with exempt securities.

Other financial service providers, such as insurance **agents/brokers** and financial planners, are currently selling a wide variety of exempt products such as limited partnerships and principal protected notes to a wide client base without being subject to SRO oversight. In our view, this is a serious regulatory gap.

c) Recommendations

In our view, any firm or individual dealing in exempt securities in any jurisdiction should be required to register. Further, this national registration category should be accompanied by substantive regulation and active oversight. Regulatory requirements applicable to other dealers with respect to capital, insurance, proficiency and business conduct should apply equally to individuals and firms in the business of dealing in the exempt market. Such entities should also be subject to on site compliance reviews.

This position reflects our strong view that effective regulatory oversight extends beyond simply promulgating rules and commencing enforcement proceedings when the rule infraction is brought to the attention of the regulator. A key ingredient in effective regulation is a robust and active compliance review program, which involves ongoing field reviews of the operations of the registrant.

3. Investment Counsel / Portfolio Managers

a) Regulation of Investment Counsel / Portfolio Managers

Currently, there are several hundred **firms** in Canada registered either as a portfolio manager or ICPM. As noted in the 2005 Advisor Sector Report from the Capital Markets Regulation Division of the British Columbia Securities Commission, **IC/PMs** have the greatest access and

* There are currently 78 MFDA Members that are registered both as mutual fund dealers and limited market dealers.

control over client assets of any other registrant. Nevertheless, the regulatory requirements that apply to ICPMs are in many ways less stringent than those for other categories of registrants. This is particularly evident when comparing the regulation of ICPMs to mutual fund dealers, which do not have discretionary authority over client assets, but are subject to stringent SRO requirements as well as regular compliance reviews.

We understand that many ICPMs have never been subject to an on-site review by a securities regulator. Over the last few years, the OSC has published summaries of common deficiencies they are finding in their examinations of ICPMs registered in Ontario. From the reports we reviewed, the findings appear to be quite consistent from year to year. Issues that are typically reported relate to fairness of allocation of investment opportunities between clients; client disclosure deficiencies; suitability and KYC issues; and personal trading issues.

b) Recommendations

In our view, ICPMs should be subject to significantly more robust and active regulation. Minimum capital, **insurance/bonding** requirements and standards of business conduct should be prescribed. Similar to our recommendation with respect to exempt market firms above, we believe that all ICPMs should be subject to a robust and active compliance review program, which involves ongoing field reviews of the operations of the registrant.

We appreciate the opportunity to provide our formal comments. If you have any questions on our submissions, please do not hesitate to contact the undersigned.

Yours truly,



Mark T. Gordon
Executive Vice-President, MFDA

Cc: Larry Waite, President & CEO, MFDA