



Mutual Fund Dealers Association of Canada
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MFDA Bulletin

Policy

For Distribution to Relevant Parties within your Firm

MFDA Investor Protection Fund Update

Attached to this Bulletin is an investor protection fund update for your information.



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Dear MFDA Member:

Re: MFDA Investor Protection Fund

This letter is intended to update Members of the Mutual Fund Dealers Association of Canada ("MFDA") as to MFDA's plans for the establishment of an investor protection fund to cover customer losses arising as a result of Member insolvencies.

Background

MFDA was recognized as a self-regulatory organization in several provinces in 2001 and, as part of the terms and conditions of such recognition, it was expected by the members of the Canadian Securities Administrators ("CSA") that MFDA would establish an investor protection fund for customers of its Members. The form of the fund and the extent of its coverage were not established at that time but the expectation was that it would replace the provincially mandated fund in certain provinces (Ontario, British Columbia, Nova Scotia – Quebec was not included) and that it may or may not have coverage protection similar to that of Canadian Investor Protection Fund ("CIPF").

In November 2002 MFDA published for comment its application to members of the CSA for approval of an investor protection fund established by a separate corporation, MFDA Investor Protection Corporation ("MFDA IPC"). In summary, the size of the protection fund was to be initially \$5 million and was to grow to \$30 million in five years. The funding was to be by assessment of MFDA Members and coverage was to be limited to \$100,000 per customer account and only in respect of mutual fund products and cash related to mutual fund sales and redemption. It was expected as part of the MFDA IPC proposal that initial assessments of MFDA Members would be made in order to establish a fund of \$5 million plus organizational costs under which the protection at the levels proposed would commence.

The public comment period for the MFDA IPC proposal expired in January 2003 and a number of comments were received. Most commentators questioned whether an investor protection fund for MFDA Members was necessary at all in view of the facts that the risks were relatively low and a high percentage of client assets were held in client versus nominee name, i.e. the customer's claim for property was directly against the mutual fund manager and not the dealer.

The CSA has confirmed that the prospect of no fund at all would not be acceptable. On that basis, commentators on the MFDA IPC proposal questioned whether the coverage available should be similar to that provided by CIPF and, consequentially, whether it made sense to have two separate investor protection funds or whether MFDA Members could participate in CIPF.

CIPF Participation

The Board of the MFDA considered the responses to the publication of the proposal for MFDA IPC and concluded, subject to certain conditions, that the prospect of MFDA participating in CIPF should be pursued. Accordingly, in the spring of 2004, discussions were commenced with the board and management of CIPF. The MFDA was (and continues to be) of the view that the businesses of mutual fund dealers are significantly different in a number of respects from those of investment dealers and, accordingly, the insolvency risks are different. As a result of the initial discussions, a formal working group consisting of representatives of both CIPF and MFDA was established to study the differences between the MFDA Rules and CIPF Minimum Standards as well as the general differences in the operations and risks of both mutual fund dealers and investment dealers. The significant differences included capital requirements, client reporting, the assessment base, distribution structures and client versus nominee holdings. This process was very open and useful and both organizations approached the exercise in a very frank and responsible manner.

At the conclusion of the review process described, it was apparent that many of the differences identified between the businesses and risks of MFDA Members and investment dealers could be resolved. However, the timeline to do so could not be completed by early 2005 as it involved amending the rules of both organizations. As well, it was premature to achieve any operational benefit from a risk based approach to field exams under CIPF Minimum Standards as MFDA would be completing its first full field exam schedule at the end of 2005.

CSA

The relevant CSA members expect customer protection to be available in respect of Members of MFDA early in 2005. The MFDA is committed to satisfying this requirement. The form of protection plan to be established is subject to approval by the CSA.

MFDA Proposal

The Board of Directors of MFDA has carefully considered the circumstances described above and has decided to proceed with the establishment of MFDA IPC as soon as possible. However, the proposal is that the customer loss coverage to be offered by MFDA IPC would be similar in substance to that of CIPF, namely that all financial products held by an MFDA Member would be eligible for coverage and that the amount of coverage per separate account would be \$1 million. In order to provide such coverage, the MFDA Board is satisfied that an initial fund containing liquid financial assets of \$30 million would be adequate. The MFDA proposes that \$5 million be raised by way of initial member assessments and that a line of credit of at least \$25 million be secured with a financial institution. The assessments expected of Members would remain generally the same as proposed in the original application of MFDA IPC in November

2002 referred to above and would consist of an initial aggregate assessment of approximately \$5 million calculated according to assets under administration, with a similar amount to be assessed over the subsequent five years. It is anticipated the first quarterly assessment of \$1.25 million would be payable on March 31, 2005 subject to CSA recognition of IPC.

Going Forward

Based on the foregoing conclusions of the MFDA Board, it is intended that the application of MFDA IPC to the relevant members of the CSA would be amended and resubmitted for approval. On the basis that MFDA IPC is to be in a position early in 2005 to establish customer coverage, the organization of MFDA IPC would proceed immediately. MFDA IPC is to have an independent board of directors consisting of a majority of public directors appointed by such board itself with the balance being industry representatives appointed by MFDA. At the same time, there will be arrangements formalized between MFDA and MFDA IPC to co-ordinate the basis on which Members are regulated, customer protection is provided and Member assessments made. The immediate requirement for MFDA IPC would be to raise the initial \$5 million by way of assessments to members during 2005 and also obtain a bank line of credit of not less than \$25 million described above.

With MFDA IPC as an interim vehicle, providing investor protection comparable to CIPF, MFDA will initiate an application to CIPF to become a sponsoring SRO of CIPF so that customers acquiring financial products from Canadian investment dealers and mutual fund dealers can look to one customer protection fund, i.e. CIPF. In order to achieve this objective, MFDA and MFDA IPC will continue to review what changes to both MFDA and CIPF requirements may be necessary and appropriate to permit MFDA to participate in CIPF. CIPF has indicated that it looks forward to an opportunity to welcome MFDA as a sponsoring SRO of CIPF.

Comments

MFDA and MFDA IPC encourage Members to provide their comments and observations with respect to the plans described in this letter. Members will be updated as to progress and some or all of MFDA IPC's application for approval to CSA members may be published for comment.

Yours very truly,



Gregory J. Ljubic
Corporate Secretary