

**Report of the Working Group
to the
Board of Directors
of the
MFDA Investor Protection Corporation**

September 2006

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I. EXECUTIVE SUMMARY

The MFDA Investor Protection Corporation (IPC) established the Working Group to review certain aspects of the IPC, including the size of the fund, its coverage policy and its assessment and funding methodologies, with the goal of ensuring the IPC fulfills its purpose of protecting investors on a failure of a member of the Mutual Fund Dealers Association of Canada (MFDA). This Report to the IPC Board of Directors describes each of the issues considered by the Working Group and sets out its recommendations. Where there is no consensus on a particular topic, the Report explains the alternative views of the members.

Investor Protection.

The risk of failure of a dealer may be reduced but not eliminated by regulations setting minimum standards for capital and risk management and by direct oversight by regulators. If a failure does occur, other provisions such as mandatory segregation of client assets may reduce client losses. An effective investor compensation scheme serves to reduce the risk of client losses further, which benefits all market participants by boosting investor confidence in the market. The Working Group notes that there remain gaps in investor protection as investors' assets may be under the control of various intermediaries, such as mutual fund managers and portfolio managers that are not covered by a comparable compensation fund, despite the fact that losses through fraud or insolvency are possible. Some of these market participants are not registered with or licensed by any regulator or supervisor and so are not subject to minimum standards or direct oversight. The CSA might want to consider what actions would be appropriate to take to protect investors dealing directly or indirectly with these entities.

Coverage Scope.

IPC coverage was reviewed along five dimensions: geographic reach, type of assets covered, location where the assets are held, what events should be covered and who should be an eligible client. The Working Group notes that it would be best if IPC coverage were closely integrated with the pooling provisions in Part XII of Bankruptcy and Insolvency Act of Canada (BIAC), designed so that it could be administered easily and be capable of being described in a manner the average investor is capable of understanding. Any limitations on coverage should be simple and unambiguous.

Geographic scope. IPC coverage does not extend to clients with accounts in Quebec at MFDA members and the assets under administration (AUA) of mutual fund assets of these clients are not subject to the IPC assessment. Quebec residents get the benefit of the Fonds d'indemnisation des services financiers (FISF) administered by the Autorité des marchés financiers. In the Working Group's opinion, the coverage provided by the IPC and the FISF should be coordinated, so that all clients of MFDA dealers get the benefit of IPC coverage regardless of where they live. The Autorité des marchés financiers and the IPC Board should work together to achieve this goal, without creating overlapping coverage or duplicating costs for dealers.

Covered assets. The Working Group considered various ways to define the assets that should be covered by the IPC. The Working Group is evenly split between two alternatives: one group favours keeping the current coverage language that includes a wide variety of assets and the other favours limiting the coverage to mutual funds and cash associated with mutual fund transactions. The latter group are concerned that coverage of a wider range of assets would expose the IPC and its members to an imprudent level of risk. The other group thinks that the IPC should cover assets that would reasonably be found in a client's account. All Working Group members agree that whatever the scope of coverage agreed upon by the IPC Board, care should be taken to explain clearly to customers what assets are or are not covered by IPC.

Location of assets. Current IPC coverage only extends to assets belonging to eligible clients held in a client account at an MFDA member dealer. This is viewed as providing too little coverage. IPC coverage should be expanded to include assets that are not available on the insolvency of a dealer that were otherwise under the control the dealer at the time of its failure, such as cheques delivered to the dealer for mutual fund purchases that go missing before the funds can be invested in client name positions.

Covered events. Similarly, the Working Group is concerned that the current language limiting coverage to losses *caused by* the dealer's bankruptcy is too narrow. The coverage language in the Ontario Contingency Fund Trust that makes reference to "losses resulting from conversion of client property" is helpful. Conversion is a wrongful act involving dealing with goods with the intention or effect of denying the title of another person to those goods. The Working Group recommends that the IPC extend coverage to losses arising as a result of the insolvency of a MFDA Member, including losses arising due to any conversion of funds or covered assets of a client while under the control of the dealer that is now insolvent.

Eligible clients. The Working Group considered several alternative ways to define who might be an eligible client for IPC coverage and recommends that the current provisions in this regard should continue.

Coverage Limit.

Several discussions took place on the coverage limit per client account. No consensus emerged. The majority view is that the current \$1 million limit should continue, despite the expectation that individual claims are unlikely to approach this limit. The minority view is that the limit should be significantly lower - \$100,000 or perhaps \$500,000 – as this more appropriately balances what reasonably might be expected to be in a client account and the potential costs to the dealer members.

Funding and Assessment Methodologies.

The Working Group considered a number of topics related to the way the IPC should fund itself in the long term, including the extent to which the IPC should be pre-funded or rely on *ex post* assessments; the target size of the fund; the proper balance between funded amounts and back up facilities such as lines of credit; and how costs should be shared between new and existing participants. The Working Group agrees the IPC should have substantial funding on hand to support dealer operations at the early stages of insolvency and to facilitate transfer of accounts. It also is of the view that the primary source of funding for the IPC should continue to be regular member assessments.

Size of fund. A precise estimate of the appropriate size of the funding that should be kept on hand at the IPC is not possible at present. The current target fund size of \$30 million was recommended by the former President of CIPF, based on his experience. This target funding size is reasonable and the IPC Board is encouraged to make regular reassessments of this target in light of actual experiences.

Assessment rate. The Report recommends a couple of significant changes in the funding methodology. In its view, it would be preferable to fix the overall assessment rate, rather than fix the total assessment to be raised and work back to the assessment rate. The IPC Board should establish a "normal rate" for annual assessments. A fixed assessment rate would tie the total annual contribution more closely to the overall state of growth of the industry. As the funding grows, the line of credit held by the IPC should be reduced, so that the overall funding available at any time equals \$30 million. As the funded size increases, there is no need to incur the standby fees charged for the full amount of the original line of credit.

Assessment cap. The IPC sets no upper limit for aggregate coverage of client losses in the event of a dealer failure. If the amount of the loss exceeds the funds on hand, the IPC has the right to make additional assessments against its member dealers. At present, there is no limit placed on these additional assessments. In theory, each dealer has an unlimited exposure to the IPC if a series of very large failures takes place. The Working Group would prefer there be a cap on the maximum that would be payable by the IPC on any single dealer failure, but accepts that IPC members should have the same liability as do the members of other compensation funds and deposit insurance schemes. IPC members also should have the benefit of a cap on the annual assessment that the IPC may impose, consistent with the practices of other comparable funds, and recommends that the terms of the IPC be amended to *introduce an annual assessment cap of twice the normal annual assessment*. The minimum fees presently in place should not be increased. Also, new dealer members should bear their fair share of contributions and should be required to pay into the IPC for a minimum of 5 years at no less than the normal rate.

Risk-based assessments. Ideally, the assessment paid by a dealer would directly reflect the risk that that particular dealer posed to the IPC. However, this assessment method is not used by other investor compensation funds, in part because of a lack of data and in part because it has been viewed as being too complicated and expensive to administer for the given premium levels.

Alternative assessment methods. The Working Group examined several alternative methods of calculating IPC assessments using a combination of factors: AUA, number of approved persons (APs), and weighting by level of dealer or how the client assets are actually held. There is no consensus in favour of any given assessment method. Given the choice between an assessment model using AUA only and one using both AUA and the number of APs, the majority view is that assessments should continue to be based on AUA only, without introducing the number of APs. The minority view is that the assessments should be based on both factors. All members agree that the AUA used to calculate assessments should include the AUA of mutual funds, as done now, and add the AUA of any other covered assets, such as the cash in the dealer's trust account.

The members are evenly split on whether the assessments should be weighted. In the opinion of one group, weighting is justified because Level 4 dealers inherently pose greater risks to the IPC, as Level 4 dealers have greater access to client assets than other dealers. The other view is that there is no compelling evidence to justify weighting as there is no present evidence of a direct link between the level of dealer and the risk of insolvency causing a loss to IPC. In the future, as experience grows, weighting based on an actual measurement of risk might be justified.

Risk Management.

The Working Group sees no present need for the IPC to become directly involved in supervising its member dealers. Active oversight of member activities should be left to the MFDA to minimize duplication of efforts and costs. However, there are a number of areas where action

should be taken to enhance risk management. In particular, dealers and mutual fund managers, working with the regulators as appropriate, should develop best practices regarding the form of registration of client name assets, the handling of client assets, and the duties and appropriate controls that should be in place regarding acting on purchase, redemption and registration instructions. Further, the value of all assets covered by the IPC should be recorded on the dealer's books and reported to the MFDA on the monthly financial questionnaire sufficiently segmented by asset type so that levels and kinds of assets can be monitored.

Client Communications.

The Report sets out nine principles that the Working Group recommends be applied in redrafting both the MFDA requirements that govern communications with clients regarding the IPC (the Policy) and the information brochure that is provided to clients of member dealers (the Brochure). In particular, the Brochure and other materials should not promise more coverage than the IPC in fact offers. Care must be taken to ensure investors are not misled about the coverage – or lack thereof – for client name assets.

II. INTRODUCTION

The Mutual Fund Dealers Association of Canada (MFDA) was recognized as a self-regulatory organization (SRO) by order of the securities commissions in British Columbia, Alberta, Saskatchewan, Ontario and Nova Scotia¹ in 2001. The recognition orders required the MFDA to create a compensation fund for clients of dealers that are members of the MFDA.

The MFDA Investor Protection Corporation (IPC) was established on November 14, 2002. Its primary purpose is to provide protection to eligible clients of MFDA dealers if the clients' property held by their dealer is unavailable as a result of the insolvency of the dealer. The MFDA, IPC and the Canadian Securities Administrators (CSA) view this coverage as being in the public interest. The IPC applied to be approved as a protection plan by the securities regulators in British Columbia, Alberta, Saskatchewan, Manitoba, Ontario and Nova Scotia and received the required approvals in May of 2005. Coverage of clients' accounts commenced July 1, 2005.

In response to comments received from the public during the securities regulators' review process, a condition was attached to the approval orders requiring that the IPC set up a working group to review various aspects of the IPC. The mandate of the Working Group that was established by the IPC Board included, but was not limited to, a review of the following topics:

- Identification of the risks of mutual fund dealer failures leading to potential investor losses;
- Consideration of the size of fund that is appropriate having regard to identified risks; amount of customer assets held in client or nominee name; average size of customer accounts; average cash flow of customer monies through the dealer, and other non-mutual fund products being covered under the fund;
- The type of products that should be covered;
- The appropriate coverage amount per customer account;
- The assessment methodology, including whether it should be risk based;
- The appropriate long term methods of funding the MFDA IPC;

¹ Further, the MFDA has applied to the securities commissions in Manitoba, Newfoundland and Labrador, and New Brunswick for recognition as an SRO and entered into a Co-operative Agreement with the Autorité des marchés financiers in Québec.

- The types of risk management tools required by the MFDA IPC; and
- The appropriate MFDA IPC advertising requirements.

The Working Group was to deliver its written report setting out its recommendations to the IPC Board and the various securities regulators. The IPC Board would then evaluate the recommendations and provide its evaluation to the regulators.

The Working Group was set up in the fall of 2005 and commenced work in November 2005. A list of the Working Group members is attached as Appendix A. The dealer members were chosen from applicants with the aim of reflecting the diversity of the MFDA membership in size, the way assets are held, scope of operations and membership level.

III. DEFINITIONS

Holding securities. The concepts relating to the holding of client assets are very important to the matters reviewed by the Working Group. The terms 'client name', 'nominee name', 'held at the dealer' and 'held at the mutual fund' came up repeatedly during its discussions. The terms combine questions of legal and beneficial ownership, whose name appears on the list of securityholders kept by the issuer or registrar, and whether and how the position appears on the statement of account issued to the client by the dealer. The concept of "holding" a security also suggests that someone has possession of some physical object, such as a stock certificate, rather than the current reality where most investments are not certificated and consist only of entries in the electronic books and records of dealers and issuers.

Held at the dealer. In this Report, securities or other assets that are registered in a name other than that of the client and the client's evidence of ownership consists of the purchase confirmation and the entries that appear on the account statements issued by the client's dealer are referred to as being **held at the dealer**. Redemptions of mutual funds held in this manner would not require the dealer to provide the mutual fund with the client's signature or a trading authority from the client. Client cash in the dealer's trust account would also be a client asset held at the dealer.

Held at the mutual fund. In this Report, where the dealer has passed along the details of the client purchaser to the mutual fund² and the ownership register kept by or on behalf of the mutual fund lists the client as the legal owner, the client's assets are referred to as being **held at the mutual fund**. Redemptions of mutual funds held in this manner would require the dealer to provide the mutual fund with the client's signature or a trading authority/power of attorney from the client. Client cash in the possession of the mutual fund manager, custodian or registrar prior to the completion of the client's purchase would also be assets held at the mutual fund. The term is **not** intended to include or refer to the mutual fund's portfolio of securities that is required to be held by the custodian.

Client name vs. nominee name. Mutual funds held at the dealer are likely to be registered in the name of the dealer, a custodian on behalf of the dealer, a trustee of a self-directed

² Many financial assets other than mutual funds may be held in uncertificated, but registered form at the issuer and so this term could have been changed to a more generic form, such as "held at the issuer". For example, the bank issuer of a term deposit purchased through a mutual fund dealer may well record the client's name on its deposit register. However, as the Working Group's discussions focussed on mutual funds that form the bulk of the client assets dealt with by mutual fund dealers, the more specific term is used in the report.

retirement savings plan or a nominee³ of any of these. Generically, these are in **nominee name**. Only Level 4 mutual fund dealers are permitted to hold client assets, other than cash, in nominee name.⁴ Following on from this, one might expect that mutual fund positions registered in the name of the client at the mutual fund would be referred to as being in **client name**. Common usage is not quite so precise and some dealers refer to any position that is not registered in their own name as being in client name, even when the actual position is recorded in the name of another intermediary, such as their carrying dealer. However, in this Report, where assets are referred to as being in client name, the Working Group means that the client is the registered owner of the asset on the books of the issuer.

Mutual fund manager. In this Report, the person or company that directs the business, operations and affairs of a mutual fund is called the mutual fund manager. The manager is not automatically required to be registered with the securities regulatory authorities,⁵ although many are registered as dealers or portfolio managers. It may act as registrar for the funds it manages or contract that activity out to an affiliate or third party.

IV. DISCUSSION

1. *Process Followed*

Many of the topics in the Working Group's mandate were inter-related and dealing with each separately often proved difficult. Despite this challenge, the Working Group developed a sequential work plan and studied each topic carefully. It reviewed information from the Canadian Investor Protection Fund (CIPF) and other Canadian contingency funds on previous dealer failures; examined the coverage provided by CIPF, the Securities Investor Protection Corporation (SIPC) in the United States and comparable funds in the European Union; identified alternatives and formulated recommendations where consensus was achieved.

The goal of the Working Group was to ensure the IPC efficiently and effectively might fulfill the purpose for which the IPC was established: to protect investors on a failure of an MFDA dealer. The Working Group agreed that a failure of dealer that resulted in client losses would negatively affect investor confidence in all mutual fund dealers. An effective investor protection fund should reduce the risk of clients losing money if their dealer becomes insolvent and therefore is in the interests of all concerned: the investing public, the dealers, the MFDA and the provincial securities regulators.

The Working Group generally took a clean slate approach to the topics under review. The only fixed requirement was that there must be an investor protection fund for MFDA members. The discussions were not otherwise constrained by the current structure of the IPC, including the relationship between the IPC and the MFDA. However, the Working Group acknowledged that it had to take note of the current requirements and be able to explain why its recommendations

³ A nominee is usually a company that is established by an intermediary to be used as its generic registered owner on stock or bond certificates. The use of nominee names simplifies the processing of security transfers and makes it clear that the assets are not the beneficial property of the intermediary.

⁴ As of June 30, 2006, the MFDA membership consisted of 61 Level 2 dealers (35% of the total number of MFDA members), 69 Level 3 dealers (39%) and 26 Level 4 dealers (26%). Level 2 dealers are not permitted to hold client cash or hold client assets in nominee name. Level 3 dealers may hold client cash in a trust account but are not permitted to hold client assets in nominee name. Level 4 dealers may hold client cash in a trust account and hold client assets in nominee name.

⁵ In some provinces, a mutual fund manager may be subject to regulatory review as a "market participant". As such, the securities commission may order an examination of the manager's financial affairs or conduct a compliance review of its books and records.

were more appropriate than the current provisions where they differed. It also took note of the discussions between the MFDA, IPC and CIPF on a possible merger of the IPC with CIPF. The prospect and ease of a protection fund merger was a relevant but not determinative factor in the Working Group's discussions.

The relationship between the IPC and the MFDA, including which entity has the ultimate decision-making authority on particular issues, was not part of the Working Group's mandate and was not discussed. The Report's recommendations are addressed to the IPC Board, as the Board is the designated recipient of the Report. However, the Working Group acknowledges that, in most cases, implementation of recommended changes will take the agreement of and cooperation by all of the IPC Board, MFDA and the CSA.

This Report describes each of the issues considered by the Working Group and sets out its recommendations. Where there was no consensus on a particular topic, the Report explains the alternative views expressed by Working Group members. A summary list of the consensus recommendations is set out in Appendix B. The Report also contains some conclusions and observations that were made during the course of the Working Group discussions that do not rise to the level of recommendations. These are not listed in Appendix B.

2. Causes of Mutual Fund Dealer Failures

In order to get a better understanding of the possible causes of dealer failures, the Working Group received presentations from representatives of CIPF, the Ontario Contingency Trust Fund and the British Columbia Contingency Trust Plan. The presenters described seventeen failures of investment or securities dealers where one of the compensation funds was involved. The representatives also explained key features of their funds, including coverage, size and funding methods. In addition, the Working Group had the benefit of a presentation by a representative of the *Autorité des marchés financiers* which is responsible for administering the protection and compensation program "Fonds d'indemnisation des services financiers" (FISF) that addressed its operations, coverage, funding and experiences as a fund that compensates victims of fraud, fraudulent practices or embezzlement that occur in connection with the distribution of financial products and services in Québec.

Two cases were of particular interest and relevance to the Working Group's deliberations: the 1998 failure of Vantage Securities Inc. (Vantage) in British Columbia and the 1999 failure of Essex Capital Management Inc. (Essex) in Ontario. Vantage was the first dealer failure to take place after the introduction of the special regime to govern securities dealer insolvencies set out in Part XII of BIAC. Both Vantage and Essex raised issues relating to the treatment of client assets recorded as being on the books of the dealer rather than on the books of the issuer of the investment. Essex also introduced issues that might arise on the concurrent failure of the dealer and related entities including issuers. For more details on these two insolvencies, please see Appendix C.

The Working Group determined that one or more of four factors was the source of most of the failures of the investment dealers or securities dealers:

- Outright fraud, as in Essex;
- Bad credit practices;
- Losses on proprietary trading; or
- Operational failures.

Even where there was no theft of client assets by the dealer, client losses were unlikely to take place unless the dealer broke at least some of the regulatory requirements governing how client assets are to be handled.

