



**Mutual Fund Dealers Association of Canada**  
Association canadienne des courtiers de fonds mutuels

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# MFDA Bulletin

## Compliance

**For Distribution to Relevant Parties within your Firm and Audit Firm**

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### Significant Financial Compliance Deficiencies Noted During On-site Examinations of Members

The MFDA Compliance Department conducts on-site examinations of all Member firms' financial reporting and operational processes to ascertain whether they comply with the applicable MFDA Rules, Policies and Notices.

The MFDA previously issued Bulletin #0056 that included common financial compliance deficiencies noted during on-site examinations. Since then, the MFDA has also issued a number of Notices and Bulletins providing additional guidance on specific financial compliance requirements.

The purpose of this Bulletin is to highlight the more serious financial compliance deficiencies identified during MFDA staff's on-site examinations of all Members, which may have resulted in material capital implications leading to Members triggering capital deficiencies or other early warning tests. Often, the cause of the deficiencies arise as a result of a firm not adequately managing or considering the capital implications of significant changes in their business such as: back office system conversions; business expansions through acquisitions or amalgamations; offering new products for distribution; or investing the firm's own capital in new or different investment products.

### Significant Deficiencies that Could Impact Any Dealer Level

#### **Incorrect Margin Rate Applied to Securities Owned**

##### *Requirement:*

The capital formula requires a margin deduction to be taken for market risk associated with the firm's securities owned and sold short. Depending upon the nature of investment held by the Member (e.g. GIC, equity mutual funds, money market mutual funds), inherently different market and liquidity risks exist and, therefore, different margin rates are to be respectively

applied. The margin rates that apply to mutual funds relate to only mutual funds qualified by prospectus for sale in any province of Canada.

*Issue Identified:*

- Member invests in hedge funds which are not qualified by prospectus and incorrectly applies a margin rate of 50% of the market value of the funds rather than 100%.

*Capital Implications:*

- Risk Adjusted Capital (“RAC”) is overstated by the difference between the margin reported by the Member and the amount that should have been calculated and reported on Statement B line 9 of the Form 1 – Financial Questionnaire and Report (“Form 1”).

*References:*

- Rule 3.5.1
- Form 1 – Notes and Instructions to Schedule 1

## **Securities not Held at Acceptable Securities Locations**

*Requirement:*

Each Member is required to ensure that all securities and other investment products held for the Member at external locations be held at acceptable securities locations, regardless of whether they be the firm’s own investments or client investments held in nominee name of the dealer. In order for the location to be considered “acceptable”, the location itself must be appropriate and a compliant custodial agreement must be in place.

*Issues Identified:*

- A compliant custodial agreement is not executed with mutual fund company or financial institution where the Member’s own investments and/or nominee name client assets are held.
- Member’s own investments are held in a custodial account that is in the name of a related or affiliated company.
- The prescribed custodial agreement has been executed by the fund manager or financial institution; however, the terms of the agreement do not extend to the specific investment product (e.g. GIC, mutual funds) held for the Member.

*Capital Implications:*

- 100% of the market value of securities and investment products not held at acceptable securities locations must be reported as a capital deduction on Statement B line 11 of the Form 1.

*References:*

- Rule 3.3.3(b)
- Member Regulation Notices MR-0058 and MR-0063
- Custodial Agreement Listing (<http://www.mfda.ca/regulation/forms/CustodialAgreements.pdf>)
- Form 1 – General Notes and Definitions
- Form 1 – Statement B Notes and Instructions

## **Incomplete Reporting on Form 1**

### *Requirement:*

Each Member is required to report its financial position and operating results to the MFDA on a monthly and annual basis in the prescribed form. This includes ensuring all accounts in the Member's general ledger, back office trading system, and other appropriate accruals are adequately reconciled and completely reported on the Form 1.

### *Issues Identified:*

- Guarantees provided by the Member for lending facilities entered into by related or affiliated companies are not reported on Statement B line 7.
- Suspense and error account balances (e.g. cash balances, security positions) are not being identified and/or reported.

### *Capital Implications:*

- Impact of non-reported balances on Form 1

### *References:*

- Form 1
- Rule 3.5.1
- Rule 5.1

## **Significant Deficiencies Impacting Level 3 and 4 Dealers Only**

### **Trust Bank Accounts not Reconciled to Back Office System**

#### *Requirement:*

Each Member is required to reconcile all its trust accounts, according to its own records to third party banking information/statements on at least a monthly basis and report the value of unresolved differences on Statement B line 13.

#### *Issues Identified:*

- Member incorrectly reports the same balance according to the trust account statement on Statement A lines 2 and 23 without reconciling the trust account statement to its back office system reflecting client cash held.
- Member performs a system conversion but does not establish adequate controls to ensure the client cash reported in the trading system continues to reconcile with the third party trust account information.

#### *Capital Implications:*

- Where client cash according to Member records is not reconciled/verified against third party information on a monthly basis, the difference is considered to be adversely unresolved. A capital deduction equal to the value of the client cash according to the Member's records not verified/reconciled to a trust account statement must be reported on Statement B line 13 of the Form 1.

*References:*

- MFDA Policy No. 4 – Internal Control Policy Statement 4
- Form 1 – Statement A and Statement B Notes and Instructions

**Incomplete Reporting on Form 1**

*Requirement:*

Each Member is required to report its financial position and operating results to the MFDA on a monthly and annual basis in the prescribed form. This includes ensuring all accounts in the Member's general ledger, back office trading system, and other appropriate accruals are completely reported on the Form 1.

*Issue Identified:*

- Trust accounts which are not included in the Member's general ledger are not being identified and reported.

*Capital Implications:*

- Impact of non-reported balances on Form 1.

*References:*

- Form 1
- Rule 3.5.1
- Rule 5.1

**Significant Deficiencies Impacting Level 4 Dealers Only**

**Nominee Name Client Assets not Reconciled to Third Party Information on a Monthly Basis**

*Requirement:*

Each Member is required to reconcile all client nominee name assets, according to its records, to third party information on at least a monthly basis and report the value of any unresolved differences on the Form 1. The reconciliation is required to be completed by the filing due date of the financial report (i.e. 20 business days for monthly filings). This process is required for all assets (i.e. mutual funds, GICs, segregated funds) held on behalf of clients but registered in the name of the Member.

*Issues Identified:*

- Member is performing a monthly reconciliation process for nominee name assets; however, the system is actually comparing third party information to the same third party information (i.e. FundSERV records are actually being compared to FundSERV records) rather than to Member records. This issue has arisen as a result of the back office system being incorrectly set up or used to capture and compare Member internally generated records to third party records.

- Member completes monthly reconciliation of all its nominee name assets to third party records; however, it is not completed by the due date of the financial report.
- Member commences the distribution of nominee name GIC business to its clients but inadvertently does not establish internal controls to capture this new line of business in its monthly reconciliation processes.
- Member expands its business by acquisition or amalgamation but does not properly establish internal controls to ensure the acquired business is subject to the same monthly reconciliation process.

*Capital Implications:*

- Where nominee name assets according to Member records are not reconciled against third party information on a monthly basis, the nominee name positions are considered to be adversely unresolved. A capital deduction equal to the market value of the nominee name assets plus the applicable margin rate on the assets must be reported on Statement B line 12 of the Form 1.

*References:*

- MFDA Policy No. 4 – Internal Control Policy Statement 4
- Member Regulation Notice MR-0051
- Form 1 – Statement B Notes and Instructions

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