

By E-mail

June 23, 2008

c/o Ms. Sarah Corrigan-Brown
British Columbia Securities Commission
701 West Georgia Street
Vancouver, BC V7Y 1L2

Dear Ms. Corrigan-Brown:

Re: Request for Comments
MFDA Recognition Order Amendments

We are writing in response to the Canadian Securities Administrators' (CSA) May 23, 2008 request for comment on proposed changes to MFDA By-law No. 1.

Introduction

Although the request for comments focuses on proposed changes to the definition of "public director" our comments are with respect to a matter that the Mutual Fund Dealers Association of Canada (MFDA) has apparently characterized as a "housekeeping matter". Specifically, in what will be paragraph 3.3.2 (currently paragraph 3.3.3) of MFDA By-law No. 1 the concept of MFDA Members (Members) "nominating" individuals from industry for election to the MFDA Board of Directors (Board) has been changed to Members merely "recommending" individuals for the Board.

This change is of concern to many Members. It should also be of concern to the members of the CSA and the provincial and territorial governments that they represent. We have attached for your reference a position paper (Paper) that was previously circulated to the CSA regarding the problems with the MFDA Board selection process. The concerns set out in the Paper still exist, as they have not yet been addressed by either the MFDA or the CSA. The Paper should be read as an integral part of this comment letter and we will therefore not repeat in this letter all of the information and discussion in the Paper.

The Problem

The fundamental problem is that Members have no opportunity for a meaningful role in the MFDA's governance and policy development, even though all members of a self-regulatory organization (SRO) must have that opportunity in order to justify the additional cost and duplicative regulation of the SRO. That is, the "S" of "SRO" must be recognized to be as important as the "RO" of "SRO"; otherwise, the SRO's role would be better carried out directly by statutory regulators.

The problem relates directly to the existing flaw in the selection of industry representatives on the Board, namely that the selection process is conducted in secret with virtually no input from the Members.

The problem manifests itself in a number of practical ways:

- the industry representatives do not reflect the diversity of Members:
 - a large majority of Members are not related to fund manufacturers but all six industry representatives are related to manufacturers;
 - most Members have under \$1 billion in assets but only one industry representative is from such a firm;
 - Members are based in all areas of the country but four industry representatives are from Toronto and one is from Montréal (even though Québec does not recognize the MFDA);
- the MFDA appears to prefer a detailed, prescriptive regulatory approach as shown in the recently-issued Member Regulation Notice MR-0069 *Suitability Guidelines* even though global trends are in the opposite direction and securities industry participants express an almost uniform preference for principals-based regulation;
- MFDA staff requires compliance with Member Regulation Notices and draft Policies as though they are enforceable rules even though, in the first case, Notices are only supposed to represent guidance and, in the second case, the CSA has not yet approved the Policies.

In more general terms, the problem manifests itself through a large segment of the membership losing confidence in the MFDA. Many Members do not view the MFDA as a fair regulatory organization with a reasonable understanding of the day-to-day operations of the membership and there are no effective avenues within the MFDA to express concern or dissatisfaction. Board members who were truly independent of management and who represented the diversity of Members would provide “safe” avenues for expressing concerns or dissatisfaction.

History

As discussed in the Paper, the MFDA was created by the CSA in response to certain studies and concerns that the growing mutual fund industry was not subject to adequate regulation. Before the MFDA’s formal recognition its draft by-laws clearly described that Members would be able to nominate individuals to fill the industry positions on the Board and that an election would choose which of the nominated individuals would fill vacant positions. This was the understanding of regulators and was also represented to provincial governments. In at least some provinces there were direct commitments that prospective Members would elect the industry representatives on the Board.

The MFDA’s own *Report of the Corporate Governance Committee on a Plan for Governance of the MFDA as Adopted by the Board of Directors*, issued in February 2003, continues to discuss

an “election” and the right of Members to elect directors (section V(c) of that Report). The Report does not discuss or suggest restrictions or limitations on Members’ ability to actually elect the industry representatives.

Leading up to the MFDA’s first annual general meeting and Board election in the fall of 2003 the MFDA requested nominations for the industry positions on the Board and a number of individuals were nominated. However, the MFDA decided that a committee would select from the nominees just enough individuals to match the number of vacancies and that Members would be restricted to voting for those individuals or withholding their votes. In effect, the committee selected the industry members on the Board since even a single vote by any Member would “elect” all of the committee’s selections. We understand that some of the members of that committee selected themselves to be on the Board, although this cannot be confirmed since there has yet to be any disclosure about the membership of that committee, the nominees they had to choose from, or the process they followed. The MFDA’s response to concerns was that their process was not illegal, hardly a standard to inspire confidence in a regulator.

Two points are clear: first, there is no element of an “election” that would be recognized in Canada – in Zimbabwe perhaps, but not in Canada – and second, the MFDA has failed to live up to commitments to allow Members to elect, in any real sense, the industry representatives on the Board.

Recommendations

The best method to address the problem is for the CSA to require the MFDA, as a condition of continued recognition, to hold open, transparent elections for the industry representatives on the Board. At a minimum an open, transparent process requires that any Member be able to nominate an individual and that Members be permitted to vote for any nominee.

There are straightforward answers to all potential objections. Issues of representation of various areas of the country or segments of the industry may be addressed by designating Board seats for those areas or segments while maintaining transparency and the integrity of a real election process. If a nominee is considered unsuitable and his or her election could harm the MFDA’s integrity – for example, there is a on-going investigation related to the individual’s conduct that will likely result in a notice of hearing by a regulator or SRO – the MFDA could seek permission from its overseeing regulator to exclude the individual from the election. This should be recognized as a remote likelihood.

A second-best alternative to address at least the transparency problem would be for the MFDA to publish a list of all nominees and the reasons for the MFDA’s selection and rejection of the individuals. Regarding concerns about a nominee being embarrassed about the reasons he or she wasn’t selected, losing is inherent in elections anyway and does not deter candidates from accepting nominations in other elections. As a stand-in for an actual election, in its oversight role the CSA should then scrutinize without a high degree of deference the nominees and the proffered reasons to assess whether the process is adequate or whether non-supportive voices are simply being excluded from the Board.

The MFDA’s answer to concerns about Member dissatisfaction is to assert that Members are satisfied and that there is no proof to the contrary. There may not be “proof” in a legal sense that

Members are dissatisfied but the dissatisfaction is a frequent subject of discussion among Members. Equally, there is no proof that Members are satisfied with the MFDA or have confidence in it. The CSA should require the MFDA to conduct a *confidential* survey of specified senior officers at all Members – at a minimum, the chief executive officer, chief financial officer and chief compliance officer at each Member – regarding their experience in dealing with the MFDA, what works well, and how the MFDA can be improved. The survey should be subject to the approval of the CSA and include detailed questions about the governance process, policy development, and the MFDA’s manner of dealing with Members. Further, the survey results should be reported to the CSA and Members at the same time it is reported to the MFDA Board and management.

Conclusion

It is clear that there continue to be problems with the governance structure at the MFDA and that the CSA needs to take steps to ensure that Members, the public, and provincial and territorial governments can have confidence in the MFDA as a self-regulatory organization. The best alternative is to create an open and transparent election process for the industry representatives on the Board.

If the CSA chooses either the second-best alternative or requires no changes at all, the CSA and the provincial ministers responsible for securities regulation should provide a justification in a sentence starting with the words “MFDA Members should not be able to elect industry representatives on the Board because ...” followed by a straightforward, plain-language reason.

We would be pleased to meet or speak further with you about our recommendations and any of the issues we have raised.

Yours truly,



Mark Kent, CFA, CFP
President & CEO



Kenneth Parker, CA
Vice President, Compliance & Finance

MFDA Board Election

Position Paper

January 2006

prepared for
Portfolio Strategies Corporation

Executive Summary

Members of the Mutual Fund Dealers Association of Canada (the “MFDA”) do not have a meaningful role in selecting the MFDA Board of Directors. In effect, the directors simply appoint new directors without having to consider the Members’ wishes. This reduces the effectiveness of the MFDA as a self regulatory organization (“SRO”) because it reduces the opportunity for input from Members in both the development and administration of rules. Additionally, there is no consistent process for seeking comments from Members before the MFDA requests securities commissions’ approval of new or amended rules, by-laws and policies. This means that the securities commissions cannot rely on the MFDA to represent the views of its Members or a breadth of industry experience when proposing rules, by-laws and policies for approval by the securities commissions, which should be one of the main advantages of an SRO.

We are proposing that the Members should be able to elect the directors through a fair, open and transparent process. This request has been made to the Board of Directors, who simply denied the request without substantive reasons. We are therefore asking the securities commissions to require the MFDA to allow Members to elect the directors. We are also asking that the MFDA be required to give Members the opportunity for meaningful input before adopting any rule, by-law, or policy.

Background

Glorianne Stromberg’s 1995 report, *Regulatory Strategies for the Mid-’90s - Recommendations for Regulating Investment Funds in Canada* (the “Stromberg Report”), recommended that all mutual fund dealers in Canada be required to be members of an SRO. Through the work of industry and the securities regulators, the Mutual Fund Dealers Association (MFDA) was established in 1997 to be that SRO.

Initially, the MFDA Board of Directors had 7 members appointed by the Investment Funds Institute of Canada, 7 members appointed by the Investment Dealers Association of Canada, and 7 public members. When the MFDA applied to the securities commissions for formal recognition as an SRO, many public comments on the application objected to the composition of the Board. Specifically, there were objections that the Board composition did not represent the future members (mutual fund dealers) and that this would prevent the MFDA from being effective as an SRO.

As a result of the public comments the securities commissions put a condition in the recognition orders requiring the MFDA to remove the right of the IDA and IFIC to appoint directors, and requiring that the Board be composed of MFDA Members and public directors. The MFDA was given one year from the date of recognition to provide an acceptable plan to the securities commissions, and three years from the date of recognition to implement the changes.

The MFDA responded with the current provisions in section 3.3 of its By-Laws, the full text of which is attached as Appendix A. Section 3.3.3, Industry Directors, begins:

At each Annual Meeting commencing in the year 2004, 3 Industry Directors shall be *elected* to fill the vacancies created by the expiry of the

terms of office of the 3 Industry Directors whose terms have expired at such meeting. [*emphasis added*]

That section further provides:

Each Industry Director to be elected at an Annual Meeting shall have been recommended by the Governance Committee to the Board of Directors for nomination for election by the Members according to the requirements of the By-laws and the terms of reference of the Governance Committee adopted by the Board of Directors.

and

Any Member shall be entitled to submit to the Governance Committee nominations for Industry Directors ...

When approving the change to the By-Laws, many of the securities regulators understood that this meant any Member could be nominated, that the Governance Committee would screen out only clearly unsuitable nominees, that Members would vote, and that the nominees who received the most votes would become the new industry directors. In other words, the “election” process would follow Canadian tradition for an election.

The Election

The new process was implemented for the December 2003 Annual Meeting. At that time, Members were informed that the Governance Committee would recommend only one nominee for each Board vacancy and that Members could only vote in favor of the Governance Committee’s nominees or withhold their votes, but they could not vote against the nominees. Members were reminded that nominations could not be made at the meeting. The practical result is that the Governance Committee selects the next year’s directors before the Annual Meeting in private without meaningful Member input and without a transparent process. They can accept or reject nominations without explanation, and they can (and did) nominate themselves for the subsequent year. Effectively, the directors are appointed privately by the Governance Committee rather than being elected by the MFDA Members and the Governance Committee is not accountable to the Members for its decisions.

Some Members were concerned about the process and took their concerns to the securities commissions who, in turn, addressed the concerns with the MFDA. The MFDA’s response was, firstly, that their process was in accordance with the By-Law and not illegal, and, secondly, that opening the selection of the Board to a vote of Members would not work because of the difficulty in achieving balanced representation and the possibility of having unsuitable individuals elected. Some Members made submissions to the MFDA last year addressing balanced representation. These were not published for comment nor do the Members have any sense that their concerns were heard or reasonably considered.

Concerns

We acknowledge there is the possibility that an entirely open election, in which any Member can be nominated and the nominees with the most votes become the new Board, could result in a Board that is not regionally balanced, or that excludes certain segments of the industry, or that has unsuitable members. However, we believe it is possible to have an election process that puts the selection of the directors in the hands of Members while addressing these concerns. We note that the by-laws of the IDA, the organization on which the MFDA was patterned, provide for nominations at the annual meeting but that none of these problems has arisen.

IOSCO

The May 2000 *Report of the SRO Consultative Committee of the International Organization of Securities Commissions* (the “IOSCO Report”) identifies reasons that statutory regulators (in Canada, the securities commissions) should support SROs. One primary reason is that industry members have a strong economic motivation to ensure that their industry is well-policed, and seen to be well-policed, and that this motivation is not as strong for statutory regulators who do not have an economic stake in the industry. A second reason is that SROs have greater flexibility than statutory regulators in developing and administering rules. A third reason is that industry input and representation contributes to a strong and effective compliance culture, while balancing the benefits and costs of regulation.

The reasons set out by IOSCO in favour of SROs depend on members of the SRO having meaningful input into the development of rules and the operations of the SRO. As a result of the input from members, the government regulator should be able to place considerable reliance on the rule and policy proposals it receives from the SRO and not have to subject these proposals to the same public comment process as rule and policy proposals of the government regulator.

However, without meaningful member input the benefits of self regulation cannot be realized. Many Members are concerned that the MFDA’s current rule and policy development process does not provide for meaningful input either with respect to which rules and policies will be developed or on the content of them. In 2004 the MFDA established a Policy Advisory Committee (“PAC”), but the members of the PAC are selected by MFDA staff, not the Members. There are no objective criteria for the selection of PAC members. MFDA staff determine whether to seek input from the PAC; there is no requirement for the PAC to review all proposed rules, by-laws or policies, or even to be involved in the major initiatives. This structure puts complete control in the hands of MFDA staff and falls short of allowing all Members to have input.

Without meaningful opportunity for feedback from Members to the MFDA about how the MFDA administers the rules and policies, there is no reason to believe that the MFDA will be any more attuned to the realities of the business than a government regulator.

Suitability of Nominees

With respect to the possibility of the election of unsuitable directors, it is important to note that every Member must be registered under the securities legislation of one or more

provinces or territories. Registration includes criminal records checks, other background screening, and industry experience requirements for officers and directors. As a result, it is very unlikely that an unsuitable person would be in a position to be nominated, much less actually elected. The likelihood of a group of unsuitable people being elected and being able to control the Board is far smaller still.

Even if that were to happen, the MFDA Board cannot change rules without the approval of the securities commissions so there is no possibility of unsuitable people being elected and then making detrimental changes to the MFDA's rules. Similarly, the MFDA's operations are subject to on-going review by the securities commissions so there is very little opportunity for a group of unsuitable individuals on the Board to detrimentally affect the day-to-day conducts of audits, investigations and enforcement proceedings. Finally, the IOSCO Report notes that industry members have strong economic motivation to ensure that their industry is regulated effectively. There is no reason to believe that MFDA Members are different from the groups studied by IOSCO.

It is also important to acknowledge that merely having a different point of view or disagreeing with the executive or other directors does not make a director unsuitable. Indeed, this type of input from Members who don't just "go along" helps ensure that the balance between the benefits and costs of a rule or regulation is considered.

Regional Representation

Current MFDA By-Law 3.2 addresses the issue of regional balance by providing that "not less than 4 of the directors shall represent regions other than the Provinces of Ontario and Québec." As of October 17, 2005, 135 of the 179 Members (75%) were from Ontario and Québec, 16 were from British Columbia, 9 from Alberta, 8 from Manitoba, 6 from Saskatchewan, 3 from Nova Scotia and 2 from New Brunswick. Five of the six industry directors are from Ontario and Québec, so to meet the requirement three of the six non-industry directors are from the other regions.

Regional balance can be protected by continuing to require that at least four directors must be from outside Ontario and Québec and by adding a minimum number of directors who must be from Ontario and Québec.

Firm Size Representation

Currently, the MFDA By-Laws do not address the issue of representation of different types or sizes of firms. The MFDA has a few large Members, who pay the bulk of the membership fees, and many smaller Members. It is reasonable to be concerned that the greater number of smaller members could control an election and that larger members would not be represented on the Board. At the same time, it is important to acknowledge that the large and small firms may have different concerns and that both need to be represented on the Board.

Appropriate firm size representation can be ensured by requiring that a minimum number of industry directors are from large Members (however defined) and that at least one director must be from a small Member.

NASD

Article VII of the By-Laws of the United States' National Association of Securities Dealers, Inc. covers matters regarding the NASD Board of Governors. Section 9 of that Article provides for a National Nominating Committee that must nominate individuals for each Board position that will be vacant. The members of the National Nominating Committee are not necessarily Governors; a Governor may only be a member of the National Nominating Committee if he or she is in the last year of his or her term, and may not stand for election while a member of the National Nominating Committee. This is in marked contrast to the MFDA's arrangement.

Section 10 of Article VII sets out a process for nomination by the members of a person who was not nominated by the National Nominating Committee. When this happens the Article refers to the election as a "contested election" and section 13 provides that the nominees who receive the most votes are elected to the Board of Governors.

Article VII provides that each Governor must be designated as Industry, Non-Industry, or Public, that there is specified representation from each of those groups on the Board, and that people are nominated to fill a vacancy in a particular group. The Article also provides that at least one Governor must be a representative of a smaller member (fewer than 150 registered persons).

Proposal

Election

The election could address regional and firm size representation in a number of different ways. One way would be to designate Board positions based on region, firm size, or both, and only permit people who met the criteria to be nominated for the position.

Another way would be to allow anyone to be nominated but disallow a nominee once all the vacancies into which he or she could fit had been filled, which could mean someone with fewer votes but from a different region would be elected. While this may not be perfectly "democratic" and would lead to a more complex voting process, it would leave the decisions with the Members. It is certainly more democratic than appointing all of the directors behind closed doors.

These are just two possibilities that we believe could strike an appropriate balance of interests. We recommend that the process chosen should be the result of discussions between the securities commissions and the Members, and that it should be published for comment with a complete explanation of how the process would actually work.

Rule and Policy Development

It is vital for the members of an SRO to have effective input when the SRO is developing by-laws, rules, and policies. There are a number of ways for the MFDA to accomplish this. A first, and necessary, step is to allow the Members to select the Board to ensure that the Board reflects the Members concerns. Additional steps will also be needed to ensure all Members have an opportunity for meaningful input in the development of by-laws, rules and policies. The MFDA could be required to seek Members' comments on proposed by-laws and rules, and to summarize and respond to the comments, before

submitting by-laws and rules to securities commissions for approval. Selection of the members of the PAC could be put in the hands of Members, rather than MFDA staff. MFDA staff could be required to consult the PAC on all by-law, rule and policy initiatives rather than only when staff choose to do so. These are only examples of the changes that could be made. We recommend that the process chosen should be the result of discussions between the securities commissions and the Members, and that it should be published for comment.

Conclusion

We believe that fundamental fairness and democratic processes require that MFDA Members be allowed to elect the MFDA directors rather than having the directors from one year simply appoint the directors for the next year. We believe that this is necessary to ensure that all Members have input at the highest level in the MFDA on rule and policy development and on the administration of the rules through compliance and enforcement. We believe there are reasonable methods to ensure that the Board is not controlled by unsuitable individuals and that there is appropriate representation from different regions and from different sizes of firms. We believe that Members must be allowed to have meaningful input in the development of by-laws, rules, and policies and that there are reasonable methods to allow all Members to have input.

We therefore ask the securities commissions to require the MFDA to allow Members to elect the directors through an open process and to require the MFDA to give Members meaningful input in the development of by-laws, rules and policies.

Appendix A

Extract from the By-Laws of the MFDA

3. DIRECTORS

3.1 Duties and Number

The affairs of the Corporation shall be managed by a Board of Directors. The number of persons comprising the Board of Directors shall be 13.

3.2 Composition of the Board of Directors

The Board of Directors shall be composed of 6 Public Directors, 6 Industry Directors and the President and Chief Executive Officer. The members of the Board of Directors (other than the President and Chief Executive Officer) shall collectively and over time be nominated and elected on the basis that there will be timely and appropriate regional representation on the Board of Directors of Members of the Corporation across Canada, provided that at any time (subject to the occurrence of vacancies) not less than 4 of the directors shall represent regions other than the Provinces of Ontario and Quebec. In addition, at any time (subject to the occurrence of vacancies) five of the Industry Directors shall be officers or employees of a Member of the Corporation or of an affiliate or associated corporation of a Member. No Member, affiliate or associated corporation of a Member shall have more than 1 director, officer, employee or other representative on the Board of Directors and, if such event should occur, the Board of Directors in its discretion may request the resignation of or remove as a director, any director or directors in order that the requirements of this section are satisfied. Each director shall be at least 18 years of age.

3.3 Election and Term

3.3.1 Initial Election

At the Annual Meeting of the Corporation when this Section 3 of By-law No. 1 is sanctioned and becomes effective, 12 directors shall be elected from persons nominated and recommended to the Board of Directors by an ad hoc nominating committee established by the Board of Directors according to the requirements of Section 3.6.1 as if that Section were in force and a Governance Committee had been established in accordance with its provisions. Of the 6 Public Directors to be so elected, the terms of 3 Public Directors to be designated by the Board of Directors shall each expire at the second and third successive Annual Meetings. Of the 6 Industry Directors to be so elected, the terms of 3 such Industry Directors to be designated by the Board of Directors shall each expire at the first and second successive Annual Meetings on the election of their successors.

3.3.2 Public Directors

At each Annual Meeting commencing in the year 2005, 3 Public Directors shall be elected to fill the vacancies created by the expiry of the terms of office of the 3 Public Directors whose terms have expired at such meeting. The term for each Public Director to be elected at an Annual Meeting shall expire at the third Annual Meeting next following such election on the election of his or her successors, unless expired earlier in accordance with this By-law. The Board of Directors shall be authorized to fix the term of any Public Director to be elected for a period of less than 3 years in order to maintain the intended staggered terms of all Public Directors, but no such term shall be shortened if the Public Director has commenced his or her term of office. A Public Director shall be eligible to serve for only 2 successive terms of 3 years which shall include any shorter term as may have been fixed by the Board of Directors in accordance with this By-law, but shall exclude any portion of a term of office in respect of a vacancy filled pursuant to Section 3.5. Each Public Director to be elected at an Annual Meeting shall have been recommended by the Governance Committee to the Board of Directors for nomination for election by the Members according to the requirements of the By-laws and the terms of reference of the Governance Committee adopted by the Board of Directors. Any Member shall be entitled to submit to the Governance Committee nominations for Public Directors provided that such nominations shall have been received by the Corporation not less than 60 days prior to the relevant Annual Meeting.

3.3.3 Industry Directors

At each Annual Meeting commencing in the year 2004, 3 Industry Directors shall be elected to fill the vacancies created by the expiry of the terms of office of the 3 Industry Directors whose terms have expired at such meeting. The term for each Industry Director to be elected at an Annual Meeting shall expire at the second Annual Meeting next following such election on the election of his or her successors, unless expired earlier in accordance with this By-law. The Board of Directors shall be authorized to fix the term of any Industry Director to be elected for a period of less than 2 years in order to maintain the intended staggered terms of all Industry Directors, but no such term shall be shortened if the Industry Director has commenced his or her term of office. An Industry Director shall be eligible to serve only 3 successive terms of 2 years which shall include any shorter term as may have been fixed by the Board of Directors in accordance with this By-law, but shall exclude any portion of a term of office in respect of a vacancy filled pursuant to Section 3.5. Each Industry Director to be elected at an Annual Meeting shall have been recommended by the Governance Committee to the Board of Directors for nomination for election by the Members according to the requirements of the By-laws and the terms of reference of the Governance Committee adopted by the Board of Directors. Any Member shall be entitled to submit to the Governance Committee nominations for Industry Directors provided that such nominations shall have been received by the Corporation not less than 60 days prior to the relevant Annual Meeting.