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MEMBER REGULATION NOTICE

CHURNING

This Notice clarifies the position of MFDA staff with respect to churning and excessive trading and the obligations of MFDA Members and Approved Persons in this regard.

MFDA staff has encountered trading practices involving mutual funds or other products that may be considered churning, which is a form of excessive trading. MFDA staff defines churning as any practice whereby an Approved Person recommends a trade or multiple trades in a client's account where the trade(s) will have little or no economic benefit for the client and where there is little or no rationale for the trade(s) other than the generation of commissions or other benefits for the Approved Person.

Background

Members and Approved Persons are obligated to deal fairly, honestly and in good faith with clients and observe high standards of ethics and conduct in the transaction of business in accordance with MFDA Rule 2.1.1. MFDA Rule 2.1.4 requires Members to ensure that any conflict of interest is addressed by the exercise of responsible business judgment influenced only by the best interests of the client. Minimum standards for account supervision detailed in MFDA Policy 2 include a requirement to review account activity for excessive trading or switching.

Mutual fund investing is typically geared towards a long term buy-and-hold strategy and MFDA staff would not expect to see frequent trading in client accounts as a general rule. A pattern of frequent trading may suggest the purpose of the transactions was simply to earn commissions.

Prohibited Trading Activity

MFDA staff has observed certain trading activities where Approved Persons earn additional compensation, but clients do not receive any discernable economic benefit, contrary to MFDA Rules 2.1.1 and 2.1.4. Transactions that are executed simply to generate commissions should be prohibited. The following are some examples of such activity:

- the redemption and subsequent re-purchase of the same fund, generating a commission on the transaction for the Approved Person; and

- the movement of money between funds in the same fund family executed as a redemption and re-purchase rather than a switch, generating a commission higher than a typical switch fee.

These transactions often involve deferred sales charge (“DSC”) funds but may also involve front-end load or other sales charge types. MFDA staff has noted that in some cases money may be “parked” temporarily between the redemption and re-purchase by purchasing a money market fund or no load fund or may be left in cash for a short period to evade controls. Depending on the situation and type of sales charge, the consequences to the client may include tax implications, redemption charges, direct costs to re-purchase a front-end fund or, in the case of a DSC fund, resetting the client’s DSC schedule.

Questionable Trades

MFDA staff has identified other transactions that may cause concern from a regulatory standpoint and, although they may be justified as being in the client’s best interests in some limited cases, they should be monitored closely as part of each Member’s trade supervision procedures.

For example, MFDA staff often finds cases where a DSC fund is redeemed and another DSC fund (i.e. not from the same fund family) is purchased. Such transactions may in some cases be executed using free or matured units where the client is not paying a redemption fee or using units where the DSC schedule has not expired and the client pays a redemption fee, which may or may not be rebated. In any case, the client’s DSC schedule is reset, which can lead to redemption fees later should the client unexpectedly require his or her funds. In addition, there may be tax implications and there is limited transparency of the commissions earned by the Approved Person.

MFDA staff is of the opinion that these and other similar transactions can only be executed if there is a valid documented reason for the trade and it is not executed simply for the purpose of increasing the Approved Person’s compensation. In the limited circumstances where such activity may be justifiable because it is in the best interests of clients, Approved Persons must provide clients with appropriate disclosure in order to comply with the conflict of interest disclosure requirements under rule 2.1.4. In staff’s view, this disclosure would include, among other things:

- a statement that the client’s DSC schedule will be reset, where applicable;
- specific detail of the amount of commissions the Approved Person will earn on the trade(s); and
- specific details of any direct costs to the client on the trade(s).

This disclosure should be provided and explained to the client at the time of each transaction and evidence that the disclosure has been provided to the client should be maintained in the client’s file. As a best practice, the Member may require clients to acknowledge receipt of the disclosure by signing a standard disclosure form to be retained by the Member. In addition, appropriate notes of any discussions with the clients should, as always, be maintained in accordance with

Member Regulation Notice MR-0035 *Recording and Maintaining Evidence of Client Trade Instructions*.

Members and Approved Persons are also reminded that disclosure or client consent cannot be viewed as a means to justify churning. All trading recommendations must be in the best interests of the client.

Policies and Procedures

Members should have policies and procedures to detect instances of churning or excessive trading and properly address these situations.

Members should generate and review reports showing trading and commission trends on a periodic basis (generally monthly or quarterly taking into consideration the Member's trading volume).

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