

MUTUAL FUND DEALERS ASSOCIATION OF CANADA
PROPOSED AMENDMENTS TO
MFDA RULE 3.1.1 (CAPITAL – MINIMUM LEVELS)
AND
MFDA FORM 1 – FINANCIAL QUESTIONNAIRE AND REPORT

I. OVERVIEW

A. Current Rules

MFDA Rule 3.1.1 prescribes the minimum capital to be maintained by Level 1, 2, 3 and 4 dealers/Members. In accordance with the requirements of Rule 3.1.1:

Level 1 Dealers

Level 1 dealers are required to introduce all of their accounts to a carrying dealer and may not hold client cash, securities or other property. Level 1 dealers are presently subject to a \$25,000 minimum capital requirement. At this time, the MFDA does not have any Level 1 dealers in membership.

Level 2 Dealers

Level 2 dealers are prohibited from holding client cash, securities or other property. Level 2 dealers are presently subject to a \$50,000 minimum capital requirement.

Level 3 Dealers

Level 3 dealers are prohibited from holding client securities or other property with the exception of holding client cash in a trust account. Level 3 dealers are presently subject to a \$75,000 minimum capital requirement.

Level 4 Dealers

Level 4 dealers are Members who act as a carrying dealer and all other Members including those who hold client securities or other property. Level 4 dealers are presently subject to a \$200,000 minimum capital requirement.

The current MFDA minimum capital requirements under Rule 3.1.1 are not consistent with National Instrument 31-103 *Registration Requirements and Exemptions* (“NI 31-103”) for Members who are licensed in multiple registration categories.

Form 1

MFDA Members are required to file a monthly and annual financial report with the MFDA in a prescribed form (“Form 1”). Currently, Form 1 requires financial information to be prepared in

accordance with Canadian Generally Accepted Accounting Principles (“Canadian GAAP”), except as modified by the MFDA and MFDA Investor Protection Corporation (“MFDA IPC”).

B. The Issues

The proposed amendments to Rule 3.1.1 are intended to ensure that MFDA Members registered in other registration categories under securities legislation are subject to consistent minimum capital requirements under MFDA Rules and NI 31-103.

Level 1 Dealers

Pursuant to section 9.3 of NI 31-103, MFDA Members that are registered solely as mutual fund dealers are exempt from the capital requirements under section 12.1 of NI 31-103. Accordingly, a Level 1 introducing dealer who is only registered as a mutual fund dealer would be subject to the MFDA’s \$25,000 minimum capital requirement. However, MFDA Members registered in other categories, including scholarship plan dealer, exempt market dealer, restricted dealer or investment fund manager, are subject to the minimum capital requirements in NI 31-103. Under NI 31-103, the minimum capital requirement for a registered dealer that is not registered as an investment fund manager is \$50,000. The minimum capital requirement for an investment fund manager under NI 31-103 is \$100,000. In light of the NI 31-103 minimum capital requirements, the proposed amendments to Rule 3.1.1 prohibit a Level 1 dealer from registering in any category of registration other than mutual fund dealer.

Level 2 and 3 Dealers

MFDA minimum capital requirements for Level 2 and 3 dealers, \$50,000 and \$75,000 respectively, meet or exceed the \$50,000 minimum capital requirements in NI 31-103 for dealers that are not also registered as a investment fund managers. A dealer that is also registered as an investment fund manager must maintain \$100,000 in minimum capital under NI 31-103. Accordingly, the proposed amendments to Rule 3.1.1 require a Level 2 or 3 dealer that is also registered as an investment fund manager to maintain the minimum capital of \$100,000.

Level 4 Dealers

No changes are being proposed to the minimum capital requirements for Level 4 dealers as the MFDA minimum capital requirements for Level 4 dealers exceed the minimum capital requirements in NI 31-103.

Form 1

The Canadian Accounting Standards Board (“AcSB”) has confirmed that International Financial Reporting Standards (“IFRS”) will replace current Canadian standards and interpretations as Canadian GAAP for Publicly Accountable Enterprises (“PAEs”), effective for fiscal years beginning on or after January 1, 2011. The proposed amendments to Form 1 are intended to align financial reporting required under Form 1 with IFRS.

C. Objectives

As noted, the objectives of the proposed amendments are to harmonize MFDA minimum capital requirements with those under NI 31-103 and to align MFDA financial reporting requirements with IFRS.

D. Effect of Proposed Amendments

Rule 3.1.1 Amendments

The proposed amendments to Rule 3.1.1, which are necessary to harmonize MFDA minimum capital requirements with NI 31-103, will not have a significant impact on Members. As noted, the MFDA does not have any Level 1 dealers in membership. Further, the MFDA has very few Level 2 and 3 dealers who are investment fund managers. The Members who operate as investment fund managers have sufficient capital to meet the proposed \$100,000 amount.

Form 1

The proposed amendments to Form 1 to conform to IFRS do not impact the MFDA's capital formula. Reporting based on IFRS, rather than current Canadian GAAP, may impact the timing and/or manner in which certain balances are reported and thus, ultimately, the calculated Risk Adjusted Capital ("RAC") balance, as defined in Form 1. The key differences between Canadian GAAP and IFRS and the related impact on RAC and the other Early Warning tests are summarized below and in the blacklined version of Form 1.

The proposed amendments to Form 1 to harmonize with NI 31-103, including changing the margin rates and the treatment of guarantees, will not have a significant impact on the entire membership based on recent financial filings. However, the change to the treatment of guarantees may impact how Members arrange financing in the future.

II. DETAILED ANALYSIS

A. Relevant History

Rule 3.1.1 Amendments

MFDA Rule 3.1.1, which establishes minimum capital requirements, has been in effect since the MFDA was first recognized as a self-regulatory organization ("SRO") in 2001. NI 31-103 is a new instrument that came into force in September 2009 and is in the process of being amended. Accordingly, MFDA Rules require amendment to conform with NI 31-103 in a number of areas.

Form 1 Amendments

In 2008, the AcSB advised that Canadian GAAP would be replaced with IFRS in 2011 for all PAEs. As a result, in 2008 MFDA staff commenced a preliminary review of the impact, if any, that the AcSB's pronouncement would have on the financial reporting requirements of the membership.

Bulletin #0328-M – *Conversion to International Financial Reporting Standards* was issued in September 2008 informing the membership of the MFDA’s position that some Members meet the definition of a PAE, and, consequently, would be required to report in accordance IFRS, whereas others would not. Accordingly, the MFDA undertook an assessment as to whether to mandate one financial reporting standard for all Members or whether to permit two different standards for regulatory reporting purposes.

In June 2009, Bulletin #0378-M – *Conversion to International Financial Reporting Standards (IFRS) – Discussion Paper/Request for Comment* was issued to solicit feedback from Members and their auditors to determine the impact on them should the MFDA require all Members to adopt reporting based upon IFRS. Following review and analysis of the comments received in response to Bulletin #0378-M, MFDA staff concluded that adopting one standard for all MFDA Members, based on IFRS, would be the best way to ensure that consistent, fair and cost-effective regulatory oversight of the membership continued. Consequently, Bulletin #0411-C – *International Financial Reporting Standards (IFRS) – Follow up to MFDA Bulletin #0378 – Conversion to IFRS* was issued in November 2009, informing the membership of the financial reporting requirements going forward. The Canadian Securities Administrators (“CSA”) and the Investment Industry Regulatory Organization of Canada (“IIROC”) also concluded that one consistent standard based on IFRS would be required for their registrants and Members, respectively. Given parallel financial reporting objectives, MFDA staff worked with IIROC staff to ensure that proposed changes relating to IFRS conversion were consistent, where appropriate.

B. Proposed Amendments

Proposed Amendments to Rule 3.1.1

The Level 1 category under Rule 3.1.1 would be amended to prohibit a Level 1 dealer from being registered in any category of registration other than mutual fund dealer. In addition, new subsection 3.1.1(b) would require Members registered as investment fund managers that are also Level 2 or 3 Dealers to maintain a minimum capital of \$100,000.

Proposed Amendments to Form 1

Relating to IFRS Conversion

Generally, the IFRS conceptual framework is very similar to Canadian GAAP, as it is principle-based with comparable objectives, characteristics and elements. Some key differences between the two standards are: (i) IFRS requires or permits reporting balances using “fair values” in cases where Canadian GAAP would require the balances to be reported at “cost”; and (ii) IFRS requires more extensive financial statement note disclosures than Canadian GAAP, as it considers qualitative information to be critical to the “true and fair” presentation of financial statements.

As noted, the current Form 1 requires financial information to be presented in accordance with Canadian GAAP *except as modified by the MFDA and MFDA IPC*. During the development of the proposed amendments to Form 1 in order to convert it to IFRS, a primary objective was to minimize

the modifications or “accounting departures” from IFRS. This was done, where appropriate, to maintain consistent presentation, as required by the standard setters and to be consistent with the approach taken by IIROC with respect to its prescribed regulatory reporting form.

In order to reflect the conversion to IFRS, changes to General Notes and Definitions have been proposed to explicitly include in the Form: (i) the prescribed departures from IFRS; and (ii) the prescribed IFRS accounting treatment in cases where alternatives are available but are not permitted by the MFDA. To ensure conformance with IFRS terminology, respective definitions and specific required disclosures have been included in the bodies of the statements themselves. This also includes presenting regulatory requirements on Statements A and B in a different manner to satisfy the objective of minimizing accounting departures from IFRS in the Form 1.

With the exception of the specified IFRS departure for client and trading balances, changes have been proposed to support the requirement under IFRS to report all balances on a “gross” rather than a “net” basis. IFRS prohibits the netting of balances unless it is required or permitted under a specific IFRS or interpretation. Generally, netting is only permitted when there is a legal right to offset; when netting reflects the substance of the transaction; and/or when gross presentation would detract from the ability to understand the transaction and assess future cash flows. Canadian GAAP also has similar requirements; however, the statements do not necessarily include lines to adequately compare the gross and net figures.

Since IFRS requires or permits fair value measurement, the difference resulting from re-valuation from cost to fair value may require reporting through Other Comprehensive Income (“OCI”), which is a component of equity not profit/loss directly from operations. Finally, required changes have been proposed to the Auditors’ Reports to comply with International Standards on Auditing (“ISA”), specifically ISA 800.

Relating to Format and Presentation (Housekeeping)

In addition to the proposed amendments to align financial reporting, as required under Form 1, with IFRS, the following housekeeping amendments are also proposed:

- (i) Additional lines added for the benefit of enhanced disclosure;
- (ii) Minor changes to the wording on the Statements, Schedules and their respective Notes and Instructions to enhance clarity and understanding of the requirements and ensure they accurately reflect current requirements;
- (iii) Moving the presentation of the Early Warning tests from Statement C to a separate Schedule. The Early Warning Tests are designed to identify financial concerns with a Member prior to a deficiency being incurred. They are more appropriately reflected in a Schedule to the Form 1 than in a Statement, as the answers to the tests are derived from the preparation of Statements A to F;

- (iv) Changes to the Certificate of Partners or Directors to accurately reflect current requirements and to update for terminology under NI 31-103; and
- (v) Adding an additional Schedule where supplemental information requested will be presented. For example, the current requirement to report Number of Salespersons and Assets under Administration on Statement D will be moved to a new Schedule and will not be required as part of the annual audited Form.

Relating to Minimum Capital Requirements under NI 31-103

With the recent implementation of NI 31-103, all securities registrants across Canada, with the exception of Members of an SRO, are required to comply with new capital requirements as set out in Form 31-103F1 *Calculation of Excess Working Capital* ("CEWC"). One potentially significant component of the CEWC is the requirement to deduct 100% of the total amount of any guarantee provided in support of another party's liabilities. For example, if the registrant provided a guarantee to the lender of a \$1 million loan provided to a related party, the registrant's CEWC would reflect a \$1 million capital deduction on the Form 31-103F1.

Currently, the MFDA's Form 1 requires a 10% capital charge be taken for guarantees provided by the Member for liabilities of other parties. In order to ensure the MFDA's Form 1 continues to at least satisfy the minimum regulatory requirements imposed on other registrants, it is proposed that the capital charge requirement for guarantees be changed from 10% to 100% of the guaranteed amount. This requirement is also consistent with IROC's capital formula.

In addition, following a review of the prescribed margin rates for a firm's own securities positions, it was identified that adjustments to the margin rates in the Form 1 were required to ensure that they at least met the minimum rates under NI 31-103. Consequently, changes to the margin rates for specific fixed income securities are also recommended at this time.

Statement B, *Statement of Risk Adjusted Capital*, Statement C, *Statement of Early Warning Excess*, and Schedule 1, *Analysis of Securities Owned and Sold Short at Market Value*, are the only sections within Form 1 that are impacted by the proposed amendments relating to minimum capital requirements under NI 31-103.

C. Issues and Alternatives Considered

No other alternatives were considered with respect to the proposed amendments to Rule 3.1.1 as these changes were made to harmonize MFDA minimum capital requirements with those under NI 31-103.

With respect to the proposed amendments to Form 1, MFDA staff undertook impact assessments with Members and their auditors to determine whether it would be more appropriate to mandate one financial reporting standard for all Members or permit two different standards for regulatory reporting purposes.

The implications of permitting two sets of reporting standards across the membership were considered as part of the IFRS review process. Two standards (i.e. IFRS and private enterprise GAAP) would require staff to be familiar with both standards and keep abreast of all changes as they arise. Further, having two standards would cause duplication of electronic filing platforms and forms and an inability to effectively compare and analyze financial data across the membership. This increase in regulatory oversight requirements would lead to increased operational costs for the MFDA and thus, indirectly, the membership.

Having regard to the findings of MFDA staff, the position adopted by the CSA and IIROC and the desirability for consistency in financial reporting among regulatory bodies to the extent possible, one financial reporting standard based on IFRS was adopted for all MFDA Members to ensure that consistent, fair and cost-effective regulatory oversight of the Membership continued.

D. Comparison with Similar Provisions

Both the CSA and IIROC have also concluded that one consistent standard based on IFRS would be required for their registrants and Members. In developing the proposed amendments to Form 1, MFDA staff gave consideration to the position adopted by the CSA and worked with staff of IIROC to ensure that proposed MFDA changes relating to IFRS conversion were consistent, as appropriate, with parallel regulatory initiatives.

One principal difference between the MFDA's and IIROC's proposed Form 1 relating to changes for IFRS conversion is that IIROC included a one-time Opening IFRS Statement of Financial Position and Reconciliation of Equity as part of IIROC's Form 1. The MFDA also intends to require this type of reporting from its membership. However, because it is a "one-time only" reporting requirement upon transitioning to IFRS, it would be filed as additional/supplemental financial information in accordance with Rule 3.5.1.

E. Technological Implications and Implementation Plan

Rule 3.1.1 Amendments

The proposed amendments to Rule 3.1.1 will not have a significant impact on systems requirements. Given Members are currently able to meet the minimum capital requirements of NI 31-103, a transition period is not necessary.

Form 1

As the primary purpose of the reporting requirements is to assess the current solvency of the firm, IFRS-compliant comparative financial statement balances will not be required for regulatory reporting purposes during the first year of transitional reporting.

MFDA staff does not anticipate that requiring financial reporting in accordance with IFRS will create widespread changes or have a significant impact on Member operations for those who would not otherwise be required to report using IFRS.

MFDA staff is aware that certain Members would not meet the definition of a PAE and would not, for any other reason, be required to report in accordance with IFRS other than for the proposed changes to regulatory reporting requirements of the MFDA. Consequently, MFDA staff is recommending that applicable Level 2 and 3 Dealers be allowed to elect to defer reporting under the new IFRS requirements proposed for up to 12 months past the fiscal year-ending. This election would be considered for any Level 2 or 3 Dealer that is not a PAE and whose fiscal year begins on January 1 to April 1, 2011.

F. Best Interests of the Capital Markets

The Board has determined that the proposed amendments are in the best interests of the capital markets.

G. Public Interest Objective

The proposed amendments are in the public interest as they will align financial reporting requirements under Form 1 with the requirements of IFRS and result in MFDA Members that are also registered under other registration categories under securities legislation to be subject to consistent minimum capital requirements under MFDA Rules and NI 31-103.

III. COMMENTARY

A. Filing in Other Jurisdictions

The proposed By-law amendments will be filed for approval with the Alberta, British Columbia, Manitoba, New Brunswick, Nova Scotia, and Ontario Securities Commissions and the Saskatchewan Financial Services Commission.

B. Effectiveness

The proposed amendments are simple and effective.

C. Process

The proposed Policy has been prepared in consultation with relevant departments within the MFDA and has been reviewed by the Policy Advisory Committee of the MFDA and the Regulatory Issues Committee of the Board. The MFDA Board of Directors approved the proposed amendments on June 3, 2010.

D. Effective Date

The proposed amendments will be effective on a date to be subsequently determined by the MFDA.

IV. SOURCES

MFDA Rule 3.1.1
MFDA Rule 3.5.1
MFDA Form 1 – Financial Questionnaire and Report
National Instrument 31-103 *Registration Requirements and Exemptions*

V. REQUIREMENT TO PUBLISH FOR COMMENT

The MFDA is required to publish for comment the proposed amendments so that the issues referred to above may be considered by the Recognizing Regulators.

The MFDA has determined that the entry into force of the proposed amendments would be in the public interest and is not detrimental to the capital markets. Comments are sought on the proposed amendments. Comments should be made in writing. One copy of each comment letter should be delivered by October 12, 2010 (within **60** days of the publication of this notice), addressed to the attention of the Corporate Secretary, Mutual Fund Dealers Association of Canada, 121 King St. West, Suite 1000, Toronto, Ontario, M5H 3T9 and one copy addressed to the attention of Julianna Paik, Senior Legal Counsel, British Columbia Securities Commission, 701 West Georgia Street, P.O. Box 10142, Pacific Centre, Vancouver, British Columbia, V7Y 1L2.

Those submitting comment letters should be aware that a copy of their comment letter will be made publicly available on the MFDA website at www.mfda.ca.

Questions may be referred to:

Laura Milliken
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Mutual Fund Dealers Association of Canada
(416) 943-5843

DOCs#212741v7

Schedule "A"

MUTUAL FUND DEALERS ASSOCIATION OF CANADA

CAPITAL – MINIMUM LEVELS (Rule 3.1.1)

On June 3, 2010, the Board of Directors of the Mutual Fund Dealers Association of Canada made the following amendments to Rule 3.1.1:

3.1 CAPITAL

3.1.1 Minimum Levels.

(a) Each Member shall have and maintain at all times risk adjusted capital greater than zero, and minimum capital in the amounts referred to below for the Level in which the Member is designated, as calculated in accordance with Form 1 and with such requirements as the Corporation may from time to time prescribe:

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Level 1 \$25,000 for a Member which is an introducing dealer and which satisfies the requirements of Rule 1.1.6(a) and (b), ~~is not a Level 2, 3 or 4 Member and is not otherwise registered in any other category of registration under securities legislation.~~

Deleted: and

Level 2 \$50,000 for a Member which does not hold client cash, securities or other property.

Level 3 \$75,000 for a Member which does not hold client securities or other property, except client cash in a trust account.

Level 4 \$200,000, for any other Member, including a Member which acts as a carrying dealer in accordance with Rule 1.1.6.

For the purposes of the By-laws, Rules, Policies and Forms, a Member which is required to maintain minimum capital at an amount referred to above is referred to as a Level 1, 2, 3 or 4 Dealer or Member, as the case may be.

(b) Notwithstanding the provisions of paragraph (a), a Member that is registered as an investment fund manager under securities legislation and is a Level 2 or 3 Dealer must maintain minimum capital of at least \$100,000.