MUTUAL FUND DEALERS ASSOCIATION OF CANADA

PROPOSED AMENDMENTS TO MFDA RULE 3.3.2

(SEGREGATION OF CLIENT PROPERTY – CASH)

I. OVERVIEW

A. Current Rule

MFDA Rule 3.3.2(e) prohibits Members from commingling money for mutual fund transactions with money held in trust for the purchase or sale of other securities or financial products (such as deposit instruments or segregated funds). The Member must maintain separate accounts, which may be designated as trust accounts, for the purchase and sale of such other securities or financial products.

MFDA Rule 3.3.2(h) requires Members to distribute interest earned in the mutual fund trust account on a cash basis to either the mutual fund companies for reinvestment or to clients directly. Pursuant to MFDA Rule 3.3.2(f), the trust account must bear interest at rates equivalent to comparable rates of the financial institution.

MFDA Policy No. 4 *Internal Control Policy Statements* prescribes requirements and provides guidance on compliance with MFDA Rule 2.9 (Internal Controls) that requires Members to establish and maintain internal controls as prescribed by the MFDA from time to time. MFDA Internal Control Policy Statement 4 – Cash and Securities prescribes requirements with respect to trust accounts for client funds.

The requirements in MFDA Rule 3.3.2 respecting commingling and the allocation and payment of interest on client cash held in trust are based on the provisions of Parts 11 (Commingling of Cash) and 12 (Compliance Reports) of National Instrument 81-102 *Mutual Funds* ("NI 81-102").

B. The Issues

Currently under Rule 3.3.2 MFDA Members are required to hold client cash in trust and segregate client cash for the investment in mutual funds separately from client cash for other investments. Additionally, MFDA Members are prohibited from earning interest on client funds held in trust. These provisions in Rule 3.3.2 reflect similar provisions in NI 81-102. Members of the Investment Industry Regulatory Organization of Canada ("IIROC") are not required to maintain a trust account and are able to earn interest on client cash. Members of IIROC are exempt from Parts 11 and 12 of NI 81-102.

With the establishment of the MFDA and MFDA IPC, there no longer appears to be a regulatory policy rationale for treating MFDA Members differently than members of IIROC

under Parts 11 and 12 of NI 81-102. The MFDA is proposing amendments to Rule 3.3.2 in contemplation of amendments to NI 81-102 that will exempt MFDA Members from the relevant provisions in Parts 11 and 12.

The amendments, as proposed, would remove the existing restrictions in Rule 3.3.2 to hold client cash for investment in mutual funds separately from client cash for other investments. The protection of client assets would not be impacted as existing requirements to segregate client cash held in trust from Member property would be maintained. Existing Rule 3.3.2 requirements in respect of the distribution of interest on client cash held in trust and related provisions would be replaced with a requirement that Members disclose whether interest will be paid and, if so, at what rate. From a regulatory perspective, these proposed amendments would not detract from investor protection and would introduce clarity and transparency that would benefit clients by requiring Members to provide interest rate disclosure to clients at account opening.

MFDA staff is aware that the proposed Rule amendments cannot be in effect until similar changes are made to the corresponding provisions of NI 81-102 and the amendments to Rule 3.3.2 are being proposed in anticipation of such changes to the National Instrument.

C. Objectives

The proposed amendments are intended to maintain investor protection while achieving a greater degree of regulatory harmonization with other self-regulatory organizations.

D. Effect of Proposed Amendments

The proposed amendments will remove commingling and related restrictions from the Rule, while maintaining the requirement to keep client cash segregated from Member property and will permit Members discretion as to whether they will pay interest on client cash held in trust, subject to conditions, including a disclosure requirement on account opening, as to whether or not such interest will be paid and if so, at what rate.

II. DETAILED ANALYSIS

A. Relevant History

<u>Commingling Prohibition</u>

In 2004 and 2005, the MFDA and provincial securities regulators received a number of requests from MFDA Members for exemptive relief from the commingling prohibition in Rule 3.3.2(e) and corresponding requirements in Parts 11 and 12 of NI 81-102. In light of the fact that the applications for exemptive relief raised an issue of general application for all MFDA Members, MFDA staff discussed with staff of the Ontario Securities Commission ("OSC"), selected as principal regulator for the application, an amendment to Rule 3.3.2(e) to delete the prohibition on commingling. However, at that time, OSC staff advised that they

could not approve such an amendment to MFDA Rules until similar amendments were made to NI 81-102. OSC staff further stated that amendments to NI 81-102 to remove the relevant provisions of Parts 11 and 12 would involve a lengthy review and approval process involving public comment.

In June 2006, the MFDA Regulatory Issues Committee granted relief from Rule 3.3.2(e) to all MFDA Members that are Level 3 and 4 dealers. As a condition of relying on such relief, Members are required to obtain relief from the relevant securities regulatory authorities from the applicable provisions of Parts 11 and 12 of NI 81-102. The Alberta, New Brunswick, Nova Scotia Securities Commissions and the Saskatchewan Financial Services Commission have granted Blanket/General Ruling Orders providing exemptions to MFDA Members from the commingling prohibitions under NI 81-102. Other securities commissions, including the OSC, which do not have the ability under their legislation to grant blanket relief orders, have granted exemptive relief on an individual basis to MFDA Members.

Distribution of Cash Held in Trust for Mutual Funds

In 2005, staff of the MFDA and Canadian Securities Administrators ("CSA") also received an exemption application requesting relief from the requirements of MFDA Rule 3.3.2(f) and (h) and similar requirements under NI 81-102. MFDA staff expressed the view to CSA staff that the relief requested raised a broader policy issue with industry-wide implications that should be considered by CSA staff through a review of the policy basis behind NI 81-102 and subsequent recommendations respecting amendments. OSC staff agreed that the issue raised by the application should not be addressed through the exemptive relief process and indicated a willingness to raise this matter with the other CSA jurisdictions with a view to considering whether amendments to NI 81-102 would be appropriate.

B. Proposed Amendments

The proposed amendments to Rule 3.3.2 will delete subsection (e) that relates to the prohibition on commingling money for mutual fund transactions with money held in trust for the purchase and sale of other securities or financial products.

In addition, the proposed amendments will remove subsection (h) that requires Members to distribute interest earned in the mutual fund trust account to the mutual fund companies for reinvestment or to clients directly and subsection (f) that provides that the trust account must bear interest at rates equivalent to comparable rates of the financial institution. Subsection (g) will also be deleted as the prohibition on the use of client funds is already addressed in Rules 3.3.1 and 3.3.2 that require Members to hold cash, securities or other property of their clients separate and apart from their own property and in trust for clients. A new subsection (e) will be added to Rule 3.3.2, which will require Members to disclose to clients whether interest will be paid on client cash held in trust and the rate of such interest. The proposed amendments will also include a requirement that any changes in the interest rate may only be made on at least 60 days written notice to the client.

The proposed amendments to Internal Control Policy Statement 4 – Cash and Securities contained in MFDA Policy No. 4 would delete sections 3, 4 and 5 under the heading "Trust Accounts for Client Funds", as these requirements would no longer be applicable in light of the proposed amendments to Rule 3.3.2. Two new sections will be added to the Policy, which will apply where Members are paying interest to clients in accordance with proposed Rule 3.3.2(e). Members would be required to segregate interest received that is owed to clients in accordance with Rule 3.3.1 and maintain adequate records of amounts owing and paid to each individual client.

C. Issues and Alternatives Considered

Administrative Costs and Complexity

MFDA Members have commented that the requirement to maintain separate trust accounts and pay interest on client cash held in trust for mutual fund transactions creates an additional administrative burden and complexity as well as costs for dealers and investment funds. The purpose of requiring a trust account is to separate client assets from the dealer's assets. One trust account is effective in segregating client cash from dealer property. Requiring further segregation of client cash into several trust accounts for different products increases administrative complexity and the likelihood of confusion and error. It has also been noted that clients often make deposits without providing investment instructions (with respect to mutual funds or other investments) or may redeem mutual funds without providing instructions on whether they want to invest in another mutual fund or another investment.

There are incremental direct monetary costs in opening, operating and maintaining more than one trust account and in allocating and distributing interest on client cash held in trust. There are also additional costs in terms of time and risk associated with having to implement internal controls and procedures to comply with these requirements. These costs are ultimately borne by investors.

Impact on Investors

While MFDA Members are currently required to pay interest on client cash held in trust at rates equivalent to comparable accounts of the financial institution, in some cases Members do not pay any interest to clients if the comparable account at the financial institution pays no interest. Further, clients are not typically aware of the fact that interest earned on client cash is paid to fund companies.

MFDA staff is of the view that replacing the current requirement to distribute interest earned on client cash held in trust with a disclosure requirement will provide greater transparency to clients. Clients will be in a better position to compare the rates offered by dealers and make more informed decisions.

D. Comparison with Similar Provisions

As noted, IIROC Members are exempt from Parts 11 and 12 of NI 81-102 and are not required to maintain a trust account to hold client cash or prohibited from earning interest on client cash.

MFDA staff has also considered that IIROC members are presently able to use client free credit balances but does not propose to seek similar amendments to Rule 3.3.2 at this time. Staff is of the view that the current requirements for client cash to be segregated from property of the Member continue to be appropriate, having regard to the capital requirements to which Members are currently subject.

E. Systems Impact of Amendments

It is not anticipated that there will be a significant systems impact on Members as a result of the proposed amendments.

F. Best Interests of the Capital Markets

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

G. Public Interest Objective

The proposed amendments are in the public interest and, in conjunction with anticipated amendments to sections 11.4 and 12.1(4) of NI 81-102, will remove requirements for which MFDA staff believes there is no longer any regulatory policy rationale reduce unnecessary administrative costs and complexity, increase transparency for investors and formalize relief that is already frequently granted to mutual funds and mutual fund dealers by CSA staff.

III. COMMENTARY

A. Filing in Other Jurisdictions

The proposed 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 amendments have been prepared in consultation with relevant departments within the MFDA. The MFDA Board of Directors approved the proposed amendments on June 4, 2009.

D. Effective Date

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

IV. SOURCES

MFDA Rule 3.3.2
MFDA Policy No. 4
NI 81-102 – Parts 11 and 12

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 September 24, 2010, 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:

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Docs # 177070

SCHEDULE A

MUTUAL FUND DEALERS ASSOCIATION OF CANADA

SEGREGATION OF CLIENT PROPERTY – CASH (Rule 3.3.2)

On June 4, 2009, the Board of Directors of the Mutual Fund Dealers Association of Canada made the following amendments to Rule 3.3.2 and MFDA Policy No. 4 *Internal Control Policy Statements*:

3.3.2 Cash

(a) **Trust Account**. All cash held by a Member on behalf of clients shall be held separate and apart from the property of the Member in a designated trust account with a financial institution (which is an acceptable institution for the purposes of Form 1).

(b) **Determination**. Each Member shall determine on a daily basis the amount of cash it holds for clients and that is required to be held in segregation pursuant to this Rule 3.3.

(c) **Deficiency**. In the event of a deficiency in the amount of cash required to be held in trust for a client, the Member shall immediately provide from its own funds an amount necessary to correct the deficiency and any unsatisfied obligation to do so shall be immediately charged to the capital of the Member.

(d) **Notice to Institution**. The Member must advise the financial institution in writing that:

(i) the account is established for the purpose of holding client funds in trust and the account shall be designated as a "trust account";

(ii) money may not be withdrawn, including by way of electronic transfer, by any person other than authorized employees of the Member; and

(iii) the money held in trust may not be used to cover shortfalls in any other accounts of the Member.

~~(e) **Commingling**. The Member shall not commingle money for mutual fund transactions with money held in trust for the purchase or sale of other securities or financial products (such as deposit instruments or segregated funds). The Member must maintain separate accounts, which may be designated as trust accounts, for the purchase and sale of such other securities or financial products.~~

~~(f)**Interest Bearing**. The trust account bears interest at rates equivalent to comparable accounts of the financial institution.~~

~~(g)**Use of Funds**. The Member shall not use any money received for the investment of mutual funds or other securities to finance its own operations.~~

~~(h)**Distributions**. The Member must have a system in place to properly distribute on a cash basis interest earned in the mutual fund trust account to either the mutual fund companies for reinvestment or to clients directly.~~

(e) **Payment of Interest**. The Member must disclose to clients whether interest will be paid on client cash held in trust and the rate. Notwithstanding this requirement, the Member may retain the interest earned in excess of the amount of interest payable to the client. The Member may only revise the rate of interest upon the delivery of at least 60 days written notice to the client.

Internal Control Policy Statement 4 – Cash and Securities

Trust Accounts For Client Funds

1. All client cheques are recorded upon receipt by the Member and deposited to the trust account on the day of receipt. If a cheque is received after normal business hours, the cheque is deposited the following business day.

2. Deposits to the trust account are balanced daily against deposit records, receivable records, and mutual fund settlement records.

~~3.Trust accounts are established to bear interest at rates equivalent to comparable accounts of the financial institution.~~

~~4.Money received from clients for investment in mutual funds is not used to finance the Member's operations. This would include offsetting bank charges with interest earned on monies held in trust.~~

~~5.The Member distributes interest earned on the mutual fund trust account on a cash basis to either the mutual fund companies or mutual fund investors.~~

3. Members must segregate interest received that is payable to clients in respect of monies held in trust for clients in accordance with Rules 3.3.1 and 3.3.2.

4. Members that pay interest to clients in accordance with MFDA Rule 3.3.2(e) must maintain adequate records of amounts owing and paid to each individual client.