Summary of Public Comments Respecting Proposed Amendments to MFDA Rule 5.3 (Client Reporting) and MFDA Rule 2.8 (Client Communications)

On June 13, 2008, the British Columbia Securities Commission published proposed amendments to MFDA Rule 5.3 (Client Reporting) and MFDA Rule 2.8 (Client Communications) (the "**Proposed Amendments**") for a 90-day public comment period that expired on September 11, 2008.

11 submissions were received during the public comment period:

1. Advocis
2. Assante Wealth Management ("Assante")
3. Canfin Financial Group ("Canfin")
4. Federation of Mutual Fund Dealers ("Federation")
5. IGM Financial Inc. ("IGM")
6. Independent Financial Brokers of Canada ("IFB")
7. The Investment Funds Institute of Canada ("IFIC")
8. Kenmar Associates ("Kenmar")
9. Primerica Financial Services (Canada) Ltd. ("PFSL")
10. Royal Mutual Funds Inc. ("RMFI")
11. Scotia Securities Inc. ("SSI")

Copies of comment submissions may be viewed on the MFDA's website at: www.mfda.ca.

The following is a summary of the comments received, together with the MFDA's responses.

1. General Comments

Industry Involvement in Proposed Amendments

Advocis recommended involving industry stakeholders at an early stage of the policy development process. Advocis noted that regulatory actions are often predicated on MFDA findings resulting from compliance reviews and commented that involving stakeholders upon first identifying a problem would result in better two-way communication, greater discussion about the nature of the problem, plausible corrective actions and greater buy-in from stakeholders when a course of action has been determined.

MFDA Response

Over the past three years, MFDA staff conducted numerous consultations with industry stakeholders on the Proposed Amendments. These consultations were conducted through the MFDA Member Regulation Forums, meetings of the MFDA Policy Advisory

Committee and other ad hoc industry meetings and involved Members, other regulators and industry participants. MFDA Members were also consulted by way of industry subcommittees which were established in 2006 and presented with the original draft of the amendments for comment. In the course of these consultations, many suggestions were brought forward and discussed. Alternative viewpoints and suggestions from Members, regulators and other participants were also discussed at length and input received by MFDA staff was factored into the Proposed Amendments.

Need for Cost/Benefit Analysis

Advocis submitted that a cost/benefit analysis is critical in determining if the benefits to be derived from the proposed regulatory intervention outweigh its costs and that such analysis should have been performed.

MFDA Response

The possibility of conducting a cost/benefit analysis of changes proposed in relation to the Client Relationship Model ("CRM") project was considered and discussed with the industry. Several meetings were held to discuss and agree upon the cost versus benefits survey approach to be pursued. However, no agreement with potential participants was reached regarding the approach to be followed in conducting the analysis.

Many of the Proposed Amendments were developed, in part, to address regulatory concerns identified in the course of the MFDA's regular compliance and enforcement activities. MFDA compliance and enforcement staff has noted inconsistencies and potentially misleading information in performance reports provided to clients directly by some Approved Persons. Some Members have adopted policies and procedures whereby the Member does not properly supervise performance reports generated by Approved Persons, but simply disclaims responsibility for the content of these reports. Such policies are inconsistent with the business conduct requirements under MFDA By-laws, Rules and Policies. The Proposed Amendments have been developed with the intent of achieving investor protection objectives while taking into account existing operational systems and the costs to change these systems. As noted above, over the past three years, the MFDA conducted numerous consultations with industry stakeholders on the Proposed Amendments and issues of cost to implement the Proposed Amendments were raised and considered. The Proposed Amendments strike an appropriate balance between managing cost considerations and addressing the regulatory issues identified by the MFDA.

Cost to Comply with Proposed Amendments

IGM noted that there will be significant costs associated with acquiring or building systems to comply with the Proposed Amendments as well as ongoing costs of delivering the required information including production and mailing costs. In addition, IGM suggested that there would be significant costs to mutual fund manufacturers to provide the necessary information to MFDA Members to meet the reporting obligations. IGM noted that costs will depend on whether fund manufacturers agree upon a common

method of reporting data to Members and to what extent service providers will support that reporting methodology.

MFDA Response

Most Members or their Approved Persons currently provide the information required by the Proposed Amendments and it is not anticipated that there will be a significant systems impact on these Members as a result of the proposals. MFDA staff acknowledges that the systems impact and costs required will be greater for Members that do not presently have the ability to provide the proposed information to clients. As such, the MFDA will provide appropriate transition periods for the implementation of the amendments to Rule 5.3.5 to allow Members sufficient time to comply with the new requirements. MFDA staff notes that the information required in Rule 5.3.5 can be included in the client's account statement thus minimizing additional costs.

Harmonization

A number of commenters noted the differences between the MFDA's Proposed Amendments and those of the Investment Industry Regulatory Organization of Canada ("IIROC") and other regulators, in particular proposals under National Instrument 31-103 Registration *Requirements* ("NI 31-103") and the requirements of the Point of Sale initiative of the Joint Forum. These commenters stressed the importance of harmonization to avoid inconsistency, duplication and overlap for the industry and also to ensure that investors are subject to similar standards of disclosure and protection.

IGM noted that, as many dealers have both an MFDA Member and an IIROC Member, the approach taken by the MFDA and IIROC should be harmonized for a variety of reasons including cost of system development. IGM commented that, although they have concerns with elements of the MFDA approach, it is preferable to IIROC's in that it is less prescriptive in nature.

MFDA Response

The MFDA has and will continue to work with the Canadian Securities Administrators and the IIROC to ensure that, after the primary objective of addressing regulatory concerns identified by the MFDA has been met, registrants are subject to regulatory requirements that are as harmonized as possible. The MFDA and IIROC have adopted different approaches in certain areas that result, in part, from differences in the business of MFDA and IIROC Members and the different ways in which the existing Rules of the two self-regulatory organizations are structured.

2. Specific Comments

Delivery of Account Statement (Rule 5.3.1)

Need for Personalized Rate of Return Information

Kenmar submitted that the requirement to provide the information set out in proposed Rule 5.3.1 is not sufficient and that clients should be provided with personalized rate of return information based on the Association for Investment Management and Research ("AIMR") or equivalent recognized standards without additional charges or fees. Kenmar suggested that performance should be disclosed for the current year and since account inception, at a minimum, and should be provided on a pre- and post-tax basis. Kenmar expressed the view that such information will result in useful questions being raised, a reduction in complaints and improvement of investor education.

MFDA Response

In drafting the Proposed Amendments, MFDA staff considered the provision of more detailed information including a personalized rate of return. MFDA staff recognized that such a requirement may involve additional costs which would ultimately be passed on to clients. The Proposed Amendments are intended to ensure that investors receive basic information as to the performance of securities in their accounts. MFDA staff believes that the Proposed Amendments achieve a balance between providing investors with useful information regarding performance and cost considerations.

Content, Format and Methodology

Advocis expressed support for the fact that Proposed Amendments have been drafted with an outcomes-based focus. Advocis noted that Rule 5.3.5 states what must be included in disclosures to clients, yet allows Members to provide the information in a format of their choosing. Advocis welcomed this flexibility as an example that consumer protection need not suffer in an outcomes-based approach to regulation.

IFIC, IGM, SSI and the Federation recommended that flexibility be provided to dealers with regard to the specific information that is to be provided and the methodology. IGM suggested that the regulatory focus should be on ensuring effective disclosure to the client of the method used, with the Member being free to choose an appropriate approach. IFIC and SSI expressed the view that regulation should focus primarily on a requirement that full disclosure be provided to the client (via Relationship Disclosure), on the specifics of the performance information that is provided and how it will be delivered. These commenters recommended that firms be given the freedom to meet their client's needs and suggested that the competitive process determine what information and methodologies will best meet those needs, rather than prescribing them by Rule.

MFDA Response

The objective of the Proposed Amendments is to ensure that all clients of MFDA Members receive basic, core information on an annual basis with respect to the performance of the investments in their accounts. The Proposed Amendments have been drafted to establish minimum standards but also permit flexibility as to how this objective can be satisfied. The MFDA recognizes that Members may adopt alternative measures that meet or exceed the minimum standards in the Rule and will be issuing a Member Regulation Notice to provide more guidance as to how the requirements under the Proposed Amendments may be satisfied. Members may provide percentage rate of return information to clients in accordance with the requirements of Rule 2.8.3 as an alternative to the information set out under proposed Rule 5.3.5(a). Rule 2.8.3 provides Members with flexibility regarding the methodology used provided it is calculated in accordance with standard industry practices and the methodology is explained to the client.

Client Name Accounts

IGM expressed concern that, with respect to client name accounts, there may be difficulty for Members in obtaining the necessary information from fund companies and inquired whether there will be an industry standard format for providing the information. IGM recommended that the Proposed Amendments clarify whether each client name account of a client with different fund companies is to be regarded as separate accounts at the Member or if collectively they are to regarded as one account, with the assumption being that the Member has assigned a single client account number for all such accounts.

Assante expressed the view that there is no distinction in the Rule relating to performance reporting for client name and nominee accounts even though Members may not have access to the information for client name accounts in order to comply with the Rule.

MFDA Response

In situations where a client opens accounts with different fund companies governed by one dealer new account application form, the separate accounts at the fund companies would be considered to be one account at the dealer.

With respect to the issue of access to information for client name accounts to comply with the Rule, we understand that most of the information required by Rule 5.3.5 is available and can be made accessible to Members provided sufficient time is permitted to implement necessary system changes. MFDA staff would be happy to discuss the issue further with individual Members affected by the Proposed Amendments.

Changing "Annual Period" to "Statement Period" (Rule 5.3.5(a)

With respect to Rule 5.3.5(a), IFIC, PFSL and Canfin recommended changing reporting from "annual period" to "statement period" as Member firms may provide this information more frequently than once a year.

MFDA Response

The requirement to provide performance information to clients on an annual basis is consistent with the general industry standard used by most portfolio managers and mutual fund managers to track fund performance on an annual and multiple-annual basis. The long-term nature of mutual fund investments also supports reporting for the "annual period" rather than the "statement period" and makes the information more useful for the client as it provides a year-to-year comparison of account performance. Members may choose to provide performance information to clients more frequently than annually provided such information is provided on an annualized basis.

"Total Assets Deposited/Withdrawn" (Rule 5.3.5(a)(ii)/(iii)

IFIC, IGM, SSI and Canfin commented that the terms "total assets deposited" or "total assets withdrawn" in Rule 5.3.5(a)(ii) and (iii) are both undefined. These commenters were of the view that prescribing these two data items may not achieve the objectives of the CRM, particularly where firms may already provide performance information that more accurately reflects changes in the account's investments as one combination of these items. The commenters suggested that reporting total assets deposited and withdrawn from the account during the period overstates the true values, particularly if there are switches in the account. IFIC and Canfin suggested that it would be preferable to provide firms with the flexibility to report either a combined net invested amount or separate total assets deposited or withdrawn. PFSL suggested that the reporting requirements would be more effective if Rule 5.3.5(a)(i) and (ii) were amalgamated so that the net amount invested in the statement period is communicated in an easily understandable manner to the client.

MFDA Response

The Proposed Amendments with respect to Rule 5.3.5 were drafted, in part, to address clients' confusion about money that had been withdrawn from and deposited into their accounts over the year. MFDA would consider the disclosure of net amount invested as an acceptable alternative to the requirement to provide total assets deposited and withdrawn.

Total assets deposited and withdrawn would not include switches as money is never deposited or withdrawn from the client's account at the dealer.

Rule 5.3.5 has been amended to include a requirement to provide the gain or loss in the account as at the end of the period covered by the report.

Treatment of Deposit Products

SSI commented that clarification is required to address the treatment of deposit products held in dealer client accounts, such as Guaranteed Investment Certificates ("GICs") or Principal Protected Notes ("PPNs") and asked how accrued interest is to be addressed in determining market values.

MFDA Response

The market value of GICs should be reported as the principle amount plus accrued interest earned as at the end of the account statement period.

With respect to reporting the value of PPNs, certain PPNs have market values that are available on FundSERV. However, for PPNs that do not have a reliable market value, the book value should be reported.

Disclosure of Information not Included (Rule 5.3.5(b)

IFIC, SSI, IGM and Canfin noted that, with respect to the disclosure requirement in Rule 5.3.5(b), there are no existing processes available to document why information is unavailable and costs to develop such systems would be prohibitive.

MFDA Response

MFDA staff is aware that system changes may be required to implement the disclosure requirement in Rule 5.3.5(b) of the Proposed Amendments. This issue will be addressed through the provision of appropriate transition periods.

Section (b) of Rule 5.3.5 would apply specifically to exempt securities such as limited partnerships for which there is no secondary market or readily available market value. If the market value of such securities cannot be readily or reliably determined, the market values must not be included in the report and disclosure of why the information has not been included in the report must be provided to the client. MFDA staff would generally expect a brief statement to the effect that the market value of the security has not been provided because the security is not frequently traded or there is no market value provided by the issuer. Members may want to consider the availability of a market value for a given product prior to selling the product.

Rates of Return (Rule 2.8.3)

Support for Proposed Amendments

Kenmar expressed support for the Proposed Amendments to Rule 2.8.3, which would require Members to approve and supervise client communications provided by their Approved Persons. Kenmar submitted that all account reporting should be generated by the Member firm and e-mailed to the client on firm letterhead.

MFDA Response

MFDA Rules currently permit Approved Persons to provide client communications such as account statements to clients directly provided certain requirements are met. Rule 1.1.7 requires that the name of the Member firm be included on all client communications including account statements.

Clarification of Standard Acceptable Industry Practice (Rule 2.8.3)

IFIC, IGM and Canfin requested clarification with respect to what are considered to be standard acceptable industry practices in Rule 2.8.3. These commenters recommended that, where an annualized rate of return percentage is provided to a client, firms be given flexibility to provide the information with disclosure of the methodology used.

IGM expressed the view that Members should have the flexibility to choose any appropriate method in calculating rates of return.

MFDA Response

Members are currently given flexibility with respect to reporting rates of return provided a standard industry method is used and a clear explanation of the method is included on the performance statement. Standard industry practices include time weighted returns such as Global Investment Performance Standards, Modified Dietz or a dollar weighted return method (Internal Rate of Return). MFDA staff will be issuing a Member Regulation Notice to provide additional guidance with respect to standard industry practices in calculating rates of return. The methodology and standards with respect to performance reporting adopted by the Member must be applied on a firm-wide basis across its entire client base and sales force. The adoption of different methodologies for different clients or Approved Persons within a Member may be misleading and used to misrepresent account performance.

Member Approval and Supervision for Communications Containing/Referencing Rate of Return (Rule 2.8.3(b))

The IFB expressed the view that the requirement for Members to be responsible for the content of and to approve any performance reports provided to clients represents a substantive change in regulation and is intrusive to the Approved Person's relationship with their client. IFB commented that the requirements in Rule 2.8.3(a)(c) were sufficient and that paragraph (b) should be deleted.

Advocis submitted that the requirement in Rule 2.8.3(b) for the Member to approve and supervise any communication containing or referring to a rate return regarding a specific account or group of accounts is problematic, and, in light of the requirement in subsection (a), redundant. Advocis noted that Approved Persons, in their conversations with clients, are regularly asked about the performance of their investments and this requirement would require the Approved Persons to speak with the compliance personnel at the Member office prior to disclosing any information. Advocis expressed the view that this requirement is needlessly broad and fails to recognize that Approved Persons often deal with their clients outside standard business hours. Advocis noted that compliance with subsection (b) would require Members to have compliance personnel available at all hours.

MFDA Response

As noted above, in the course of compliance examinations and enforcement activities, MFDA staff has identified inconsistencies and potentially misleading information in performance reports provided to clients directly by some Approved Persons. MFDA Rule 2.8.2(a) currently provides that no client communication shall be untrue or misleading. Accordingly, there must be adequate supervision to ensure that such misleading communications are not provided to clients.

With respect to the requirements in proposed Rule 2.8.3(b), reference is made to "client communication", which is defined in Rule 2.8.1 as "any written communication by a Member or Approved Person to a client of the Member, including trade confirmations and account statements, other than an advertisement or sales communication". Accordingly, only written communications and not verbal conversations that reference performance are subject to the requirements of Rule 2.8.3(b). In addition, Rule 2.8.3 requires Member supervision of client communications containing a rate of return regarding a specific account or group of accounts and does not require Member supervision of a rate of return provided for specific products.

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