

**July 4, 2011**

On July 9, 2010, the Canadian Securities Administrators (CSA) published an Oversight Review Report on the performance of the Mutual Fund Dealer Association of Canada (MFDA). At that time, the CSA decided not to include the section of the report that dealt with the governance of the MFDA due to a hearing before the BCSC respecting governance issues.

The decision in the hearing before the BCSC was published on January 12, 2011, and we are now publishing the governance section of the oversight review.

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**Oversight Review of  
the Mutual Fund Dealers Association of Canada**

**Corporate Governance Report**  
(Review Period: July 1, 2005 to December 31, 2008)

**July 4, 2011**

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## **I. Executive Summary**

### **1. Background**

The Mutual Fund Dealers Association of Canada (MFDA) is recognized as a self-regulatory organization (SRO) for mutual fund dealers by the Alberta Securities Commission (ASC), British Columbia Securities Commission (BCSC), Manitoba Securities Commission (MSC), New Brunswick Securities Commission (NBSC), Nova Scotia Securities Commission (NSSC), Ontario Securities Commission (OSC), and Saskatchewan Financial Services Commission (SFSC), collectively, the Recognizing Regulators (RRs)<sup>1</sup>.

The RRs rely on the MFDA to carry out certain regulatory functions. The Recognition Orders (ROs) detail these responsibilities and the MFDA has agreed to the terms and conditions (T&Cs) within the ROs as it carries out those responsibilities. The RR staff conduct periodic oversight reviews of the MFDA to ensure it is complying with the ROs.

From January 26 to March 13, 2009, RR staff conducted an oversight review of the MFDA. BCSC staff performed a review of the MFDA's corporate governance for the period July 1, 2005 to December 31, 2008 (the Review Period). This report does not include a review of events subsequent to 2008. However, it does refer to certain events that occurred while BCSC staff were conducting the onsite review.

On July 9, 2010, the RRs published a consolidated report of the review, but deferred issuing the corporate governance section<sup>2</sup> because certain governance matters were subject to a BCSC hearing and review at the time. The BCSC hearing and review has concluded and the RRs have finalized this section of the 2009 MFDA Oversight Review.

Since our onsite review, the MFDA has addressed some of our concerns.

### **2. Overall assessment of corporate governance**

Overall, BCSC staff were satisfied with the MFDA's corporate governance framework that existed during the Review Period. However, BCSC staff noted concerns with the MFDA's governance practices, affecting its ability to populate its board to comply with its ROs and by-laws.

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<sup>1</sup> In 2001, the original RRs, the ASC (April 10), BCSC (February 15), NSSC (November 26), OSC (February 6), and SFSC (February 15), recognized the MFDA as an SRO. Subsequently, the MSC and the NBSC recognized the MFDA on May 31 and July 23, 2007, respectively. The ASC revoked and replaced its RO on May 18, 2004; the BCSC amended and restated its RO on June 3, 2004; the NSSC amended and restated its RO on April 8, 2004; the OSC amended and restated its RO on March 30, 2004; and the SFSC amended and restated its RO on April 16, 2004. In Québec, the MFDA is not recognized or approved as a SRO, so the MFDA cannot directly regulate the activities of MFDA members and their Approved Persons. The MFDA signed an agreement to cooperate with the provincial regulators of Québec, the Autorité des marchés financiers du Québec and the Chambre de la sécurité financière.

<sup>2</sup> As the Principal Regulator of the MFDA, BCSC staff were the sole reviewers of the MFDA's corporate governance function at the MFDA's Toronto head office.

## **II. Corporate Governance**

### **1. Introduction**

The MFDA is required to meet public interest objectives. These objectives provide overarching guidelines that inform the MFDA's corporate governance principles. As a SRO, the MFDA's credibility and effectiveness with its members is dependent on it being, and appearing to be, unbiased. To achieve its public interest objectives and maintain its credibility and effectiveness, the MFDA must ensure that it is supported by governance structures and processes outlined in the RO as well as generally acceptable standards.

### **2. Purpose**

The purpose of this part of the review is to assess the MFDA's corporate governance processes against a range of generally acceptable characteristics of effective governance and the MFDA's performance in discharging its governance responsibilities. Specifically, BCSC staff examined this area to ensure that the MFDA's governance structure and processes comply with the T&Cs of the RO and the requirements of the MFDA *By-law No. 1*.

### **3. Scope**

While the RO provides broad guidance on board composition and governance structures, BCSC staff also assessed the organization's compliance with its RO based on internationally recognized principles that underpin effective governance. Therefore, our review included a critical look at whether the MFDA incorporated these characteristics of effective governance into its governance processes, taking into account the nature, scope and complexity of its operations.

Our review covered the following:

- board composition
- board nomination and selection processes
- repopulating the board
- board and board committee mandates
- reporting, deliberating and resolution processes
- strategic, business and financial planning processes

We reviewed the above processes taking into consideration the following characteristics of governance:

- judgment
- initiative
- transparency
- risk management
- responsiveness
- independence
- internal control
- reporting

#### **4. Prioritization of report recommendations**

The recommendations in this report are prioritized into high, medium, and low priority, based on the following criteria:

High – the issue is of significant importance or relates to a repeat finding of some significance. The MFDA should take corrective action immediately and regularly report on its progress on implementing the recommendation.

Medium – the MFDA should resolve the issue within a reasonable timeframe. The MFDA may be required to report on its progress on implementing the recommendation.

Low – these issues were brought to management’s attention for review and consideration.

#### **5. Governance structure**

##### ***Background information***

The MFDA provided BCSC staff with various materials and documented procedures<sup>3</sup>.

The RO sets out the RRs’ expectations for the MFDA’s governance structure. Accordingly, the MFDA’s governance structure must conform to the following requirements:

- the MFDA’s board of directors should reflect a balance between the interests of the members of the MFDA in order to ensure diversity of representation on the board.
- the MFDA board of directors and board committees should include a reasonable number and proportion of public directors, recognizing that protecting the public interest is one of the primary goals of the MFDA.

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<sup>3</sup> The materials and documented procedures were:

- list of board and board committee members during the Review Period, including the biography of each board and board committee member
- the terms of reference for each board committee
- board nomination procedures
- copy of board and board committee minutes of meetings held during the Review Period
- board and board committees’ Annual Work Plan.

Because the ROs required the MFDA review its governance structure to ensure diversity of its board of directors, the MFDA established a Corporate Governance Committee (CGC). In 2003, the CGC reached the following conclusions:

“While a board with a strong minority of public directors could likely provide effective regulation of MFDA members in the public interest, the expectations of the public, governments, regulators and members themselves appear to warrant equal public and industry representation. In addition, while members of the MFDA should have some flexibility in selecting whomever they wish to represent the industry or "non-public" interests, the benefits of direct industry participation require that a high proportion of industry directors be representatives of member firms”.

The CGC also agreed that the members of the board (other than the CEO) must reflect four primary diversity factors, namely, regional representation, business size, business type, and ownership structure. The intent of these recommendations was to ensure the MFDA was not hindered, by bias or otherwise, in achieving its public interest objectives.

The MFDA subsequently, amended its by-laws to reflect these recommendations.

**(a) board composition**

***Background information***

Public/Industry Balance

The CGC recommended the following board composition:

- the board must comprise 13 directors
- at least 50% of its directors, other than the President and Chief Executive Officer, shall be public directors
- five of the industry directors must be officers or employees of MFDA members, or affiliated or associated organizations

Diversity of Representation

To meet the diversity requirements of the RO the by-laws of the MFDA specifically require that not less than four of the directors represent regions other than Ontario and Québec. In addition, no MFDA member, or its affiliated or associated organizations, can be represented by more than one industry director at any time.

While the MFDA’s by-laws set out the requirements for regional diversity, the requirements for diversity of size and ownership representation are set out in the governance committee’s terms of reference. BCSC staff reviewed the materials and documented procedures provided, and discussed the current board composition with selected board members.

***Staff findings***

BCSC staff noted the board composition complied with the requirements for diversity of industry and regional representation as specified in the by-laws. However, due to the delay in filling intermittent vacancies during the Review Period, the board composition did not comply with the requirements of the RO and by-laws governing the appointment of public directors.

BCSC staff did not find any evidence indicating that a prolonged public director vacancy negatively affected or influenced the board’s decision-making or oversight activities. However, this continued breach of the RO is a reputational risk and may undermine stakeholders’ confidence in the board’s ability to discharge its oversight responsibilities.

***Staff recommendations***

The MFDA should act expeditiously to correct the noted imbalance in its board composition.

BCSC staff acknowledges that the MFDA is currently reviewing the MFDA’s governance processes.

***Priority:*** High.

***MFDA Response:***

*The MFDA acknowledges and agrees with the requirements of its ROs with respect to board composition and believes it currently complies with them and will continue to do so. As noted by BCSC staff in this Report and as discussed subsequently in further detail with BCSC staff, MFDA through its Governance Committee is currently assessing some of its governance processes including those that have been the subject of prior proposals such as the implementation of By-law No. 15 and related procedural amendments.*

***Staff comments and follow-up:***

The MFDA’s response is adequate. No further action is necessary.

**(b) The board nomination and selection process**

***Background information***

The CGC Report recommended that the process for identifying and recommending persons for nomination and election to the board should remain with the MFDA’s Governance Committee. The CGC felt that, except for the regional representation requirement, a more prescriptive approach would yield less satisfactory results and recommended reliance on the judgment and discretion of the members of the Governance Committee. It was felt that this approach allowed the Governance Committee the flexibility to balance the diverse interests of members and the public.

Section 3.3.2 of By-law No. 1 states, among other things:

*“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”.*

Section 3.3.3 contains a similar provision with regard to industry directors.

Prior to each Annual General Meeting (AGM), the MFDA sends a letter and explanatory attachments to the executive office of each member firm inviting suggestions for candidates for election to the board of directors.

BCSC staff reviewed the MFDA’s communications to its members, with regard to the nomination and election procedures, the AGM materials and post-AGM correspondence to unsuccessful board candidates. BCSC staff reviewed the governance committee’s minutes for the Review Period. BCSC staff also interviewed the governance committee members and other selected board members.

#### ***Staff findings***

The MFDA has established procedures for populating its board of directors. During the Review Period, the Governance Committee formalized and documented a suitable process to screen the eligibility of candidates for nomination as public directors. A similar eligibility screening process was established for potential industry nominees. Screening criteria meet the requirements outlined in the RO and the MFDA by-laws.

The governance committee minutes reflected discussions about the prescribed board diversity requirements. However, staff found no documented evidence in the minutes in support of the governance committee’s final decisions in situations where two or more candidates met the prescribed eligibility criteria. Consequently, in instances where two or more proposed nominees had similar eligibility criteria, it was not clear how the governance committee made its ultimate choice.

BCSC staff acknowledge verbal representations from the MFDA’s board members that, in making its decisions, the governance committee applies its judgment and discretion in matching the attributes of available individuals with the needs of the MFDA. Except for the above-mentioned prescribed eligibility criteria, BCSC staff were not able to find evidence of the discussions about what attributes the committee considered in making its final decisions in every case. The lack of documentation made it difficult to evaluate the nature and extent of the deliberations.

In addition, communication with members concerning the ultimate selection did not clearly explain the rationale supporting the selection. BCSC staff noted correspondence to unsuccessful candidates that, while providing no reason for the candidates’ failure in their bid for nomination, encouraged the unsuccessful candidates to resubmit applications in following years. Candidates and the membership at large could lose confidence in a

process that provides no rationale for repeated unsuccessful board nominations. The absence of documentation gave rise to member inquiries about the transparency and independence of the board selection process.

***Staff recommendations***

The MFDA should improve its governance committee's documentation of the board nomination and selection process.

To provide clarity to members, the MFDA should review and revise the process for the nomination and selection of directors. It should consider:

- disseminating the governance committee's selection criteria to its members,
- revising correspondence to unsuccessful candidates
- developing a matrix of desirable skill and attributes that, in the judgment of the governance committee, meet the requirements for participation on the MFDA's board

BCSC staff noted that the MFDA's board of directors established a Task Force on Governance Issues to review, among other things, the board nomination and selection processes. The Task Force considered and recommended appropriate responses and actions to the board.

***Priority:*** High.

***MFDA Response:***

*The MFDA agrees that aspects of its nominating process can be better documented. In particular, the selection criteria for its Directors should be clear and transparent to the extent practical and a matrix of desirable skills and attributes to be satisfied at any time or over time is in order and should be available to Members. These were specific recommendations of the Task Force on Governance Issues in 2009 and are in the process of being developed. However, the strength of a robust and effective nomination process is the judgment of experienced and representative members of a nominating committee in applying the criteria selected to the various candidates identified. There is no "check-the-box" threshold or approach to eligibility for candidates who are equally suited to be members of a board such as that of MFDA which is required to meet specific composition requirements. Nor, in MFDA's view, is there a sound governance or legal principle on which an unsuccessful candidate is owed an explanation of why he or she was unsuccessful. The test for success is whether Members and the public are confident that the process is fair and the result is an effective board whose composition satisfies the diversity criteria.*

***Staff comments and follow-up:***

BCSC staff will continue dialogue with the MFDA with regard to the MFDA's development of revised governance processes.

### **(c) Repopulating the board**

#### ***Background information***

In the event of a vacancy in the MFDA board of directors, MFDA by-laws provide the board with the authority to fill the vacancy without soliciting candidates from its membership.

*Section 3.5 of By-law No. 1 provides that: “the vacancy shall be filled by a resolution electing or appointing a director passed, by either a majority of the votes cast at a meeting of the members or the board of directors provided that in either case the director has been identified and recommended by the Governance Committee to the board of directors for nomination and the nominee is otherwise qualified as a director. In recommending any such nominee as a director, the Governance Committee shall ensure the requirements for the composition of the board of directors set out in Section 3.3.2 are satisfied and that the nomination process followed by the Governance Committee shall be in accordance with the requirements for nominees to be recommended to the board of directors for the election of directors at Annual Meetings except that no notice of the vacancy or request for nominations need be given to members”.*

BCSC staff reviewed governance committee minutes, interviewed selected members of the board of directors and discussed the public director eligibility criteria screening process.

#### ***Staff findings***

The MFDA has an established process for repopulating the board to its required composition in the event a board member cannot complete the term of office.

However, the broad criteria that define a public director often result in less than timely recruitment of public directors. Consequently, the MFDA has experienced significant delays in filling unexpected public director vacancies. The potential for delay is a weakness in the MFDA’s governance processes that could lead to heightened reputational risk. BCSC staff noted that the MFDA is actively pursuing revisions to its governance processes.

#### ***Staff recommendations***

The MFDA should mitigate the noted weakness in its board nomination and selection process by developing and maintaining a pool of potential candidates that meet or could meet its director eligibility criteria in the short run. This “evergreen list” would reduce the potential delay in filling future unexpected vacancies.

***Priority:*** High.

**MFDA Response:**

*MFDA agrees it is necessary to fill board vacancies promptly. However, it does not believe that a formal pool or "evergreen list" of candidates is practical in view of continuously changing circumstances and required director competencies. The Governance Committee and individual directors are mindful on an ongoing basis of identifying potential candidates and previously considered candidates are included. In addition, MFDA has had recourse to professional search firms who have potential candidate lists at hand.*

**Staff comments and follow-up:**

BCSC staff will continue dialogue with the MFDA with regard to the MFDA's development of revised governance processes.

**(d) board and board committee mandates**

***Background information***

The MFDA provided BCSC staff with the *Board of Directors Handbook (Handbook)* that included a description of the role and duties of the board, as a whole, and the terms of reference of the board committees. The *Handbook* includes a summary of the role and duties of a director as well as the potential liability of directors. The terms of reference of the board committees set out the role of the committees including their duties and responsibilities, composition, frequency of meetings, and committee members' attendance requirements.

BCSC staff discussed board-monitoring safeguards, such as board assessment processes, with selected board members and the Corporate Secretary. BCSC staff also discussed board orientation processes with the Corporate Secretary.

***Staff findings***

The board and board committees have well documented mandates that set out the respective roles and responsibilities. These mandates are clearly articulated. The governance committee reviews all mandates and updates them annually.

The MFDA also has processes in place to monitor board performance and individual board members.

***Staff recommendations***

None.

***MFDA Response: Agreed***

**(e) board, board committees and management processes for reporting, deliberating and resolving matters**

***Background information***

For the Review Period, the MFDA provided BCSC staff with minutes of the following committees:

- Audit and Finance
- Governance
- Regulatory Issues
- Executive

BCSC staff also reviewed the meeting agendas and related preparatory materials provided to board members for the board and board committee meetings.

BCSC staff discussed the board reporting structure, and senior management processes for escalating issues to the board.

***Staff findings***

In general, there is sufficient, relevant and timely information from senior management and board committees to support board decisions.

However, the MFDA does not have a process to specifically track and report potential breaches of its ROs to the RRs.

***Staff recommendations***

MFDA needs to improve its accountability to RRs by establishing an early warning reporting to alert the RRs of matters that might breach the T&Cs of its ROs.

Priority: High.

***MFDA's Response:***

*MFDA agrees that monitoring compliance with its ROs (and other legislative and regulatory) requirements is important and will do so.*

***Staff comments and follow-up:***

The MFDA's response is adequate. No further action is necessary.

**6. Strategic, business and financial planning processes**

***Background information***

In October 2003, the MFDA completed a strategic plan covering the period 2004-2006. This plan formalized operating processes in support of the MFDA's core regulatory responsibilities.

From 2005 to 2008, with its regulatory activities now operational, the MFDA's strategic focus shifted to leadership, collaboration, staff excellence, and regulatory best practices, reflecting the goals of a maturing regulatory institution.

BCSC staff reviewed the MFDA's strategic plan and risk management report, and discussed the components with senior management and selected members of the board.

***Staff findings***

Based on BCSC staff's review and discussions, it appears that board members are integrally involved in guiding the MFDA's strategic direction. The strategic planning processes are adequate and they enable the MFDA to deal with emerging industry trends and attendant risks.

***Staff recommendations***

None.

***MFDA Response:*** Agreed

**7. Summary assessment of findings**

BCSC staff found that, during the Review Period, the MFDA had a comprehensive governance framework that provided a structure for oversight and accountability. The board and board committees had well documented mandates that set out their respective roles and responsibilities. The directors had clearly articulated roles and responsibilities.

.However, BCSC staff noted concerns with the MFDA's governance practices, affecting its ability to populate its board to comply with its ROs and by-laws. In particular, the inability to fill unexpected board vacancies resulted in a prolonged imbalance in the board composition.

The lack of clarity in the governance committee's communication to MFDA members, led to questions from its members about the validity of the selection process for potential board nominees.

***MFDA Response:*** See MFDA responses above.