

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

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## **I. Executive Summary**

In accordance with their mandates under the securities legislation of their respective jurisdictions, the Recognizing Regulators<sup>1</sup> of the Mutual Fund Dealers Association of Canada (MFDA) have jointly completed an annual risk-based oversight review (the Review) targeting specific processes within the following functional areas:<sup>2</sup>

- Sales Compliance
- Membership Services
- Financial Operations
- Corporate Governance

No findings were identified during the Review, and Staff of the Recognizing Regulators (Staff) concluded that the MFDA is meeting the relevant terms and conditions of the recognition orders (the ROs) in the functional areas reviewed.

Staff acknowledges that the MFDA made sufficient progress in resolving the findings which were cited in previous oversight reports and which were followed up by Staff prior to the Review.

## **II. Introduction**

### **A. Background**

The MFDA is the national self-regulatory organization (SRO) that oversees all mutual fund dealers in Canada.

The MFDA is recognized as an SRO by the Alberta Securities Commission (ASC), the British Columbia Securities Commission (BCSC), the Financial and Consumer Affairs Authority of Saskatchewan (FCAA), the Financial and Consumer Services Commission of New Brunswick (FCNB), the Manitoba Securities Commission (MSC), the Nova Scotia Securities Commission (NSSC), the Ontario Securities Commission (OSC), and the Prince Edward Island Office of the Superintendent of Securities, collectively, the Recognizing Regulators. The MFDA's head office is in Toronto with regional offices in Calgary and Vancouver.

The Review was conducted jointly by staff of the ASC, BCSC, FCAA, FCNB, MSC, NSSC and OSC. The Review covered the period from February 1, 2017 to January 31, 2018 (the Review Period).

This report details the Review's objectives and the fieldwork conducted by Staff, including the key inherent risks which informed it. The methodology, report format, and

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<sup>1</sup> See part II. Introduction, section A. Background for the regulators that recognize the MFDA.

<sup>2</sup> See Appendix A, section 3 for a detailed description of the scope for the oversight review.

scope are set out in Appendix A. A description of the applicable regulatory requirements and functional areas are set out in Appendix B.

**B. Objectives**

The objectives of the Review were to evaluate whether selected regulatory processes were effective, efficient, and were applied consistently and fairly, and whether the MFDA complied with the terms and conditions of the ROs.

### III. Risk Assessment and Fieldwork

#### A. Sales Compliance

As part of the annual risk assessment process, Staff determined that Sales Compliance had an above average adjusted risk score.<sup>3</sup> Staff identified the following key inherent risks<sup>4</sup> that were the focus of Staff's on-site examination work:

- inadequate exam program including the transition to and implementation of the Electronic Working Paper (EWP) system
- untimely or insufficient changes to the examination programs to address emerging issues
- ineffective communication with other MFDA departments
- improper sales incentives where the interests of the member/approved person may conflict with those of the client and may lead to client harm

To ensure that the MFDA has controls in place to mitigate the key inherent risks identified, Staff focused the Review on assessing:

- the adequacy of the processes for and implementation of the EWP system including
  - complete transfer of program steps from the previous system
  - EWP policies and procedures
  - EWP training for sales compliance staff
  - file documentation
- the progress and timeliness of implementing Client Relationship Model 2 changes including changes to the examination program
- the adequacy of policies and procedures for and timeliness of referring matters to Enforcement and the role of Sales Compliance subsequent to the referral
- the adequacy of monitoring and review of member compensation and incentive programs

In carrying out the above, Staff utilized the methodology set out in Appendix A.

Based on the work performed, Staff is satisfied that the MFDA has adequate processes in place to mitigate the key inherent risks Staff identified.

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<sup>3</sup> See Appendix A, section 1 for a detailed description of the risk-based methodology used in all functional areas.

<sup>4</sup> See Appendix A, section 1 for the methodology used to identify key inherent risks in all functional areas.

## **B. Membership Services**

As part of the annual risk assessment process, Staff determined that Membership Services had a moderate adjusted risk score. However, because the oversight review methodology requires that each functional area be reviewed at least once in a 5-year cycle, Staff ensured that mitigating controls were in place to prevent the following key inherent risks:

- inadequate policies and procedures including ineffective communication or follow-up with other MFDA departments
- inadequate or untimely processing of applications for membership, member requests, or member notices including inadequate communication with the applicable provincial regulatory staff regarding registration requests of an approved person
- inadequate follow-up and monitoring of terms and conditions imposed on members, late filing fees, outstanding accounts, and applicable exemptions/file waivers

As a result, Staff's on-site examination work focused on assessing the adequacy of:

- Membership Services' policies and procedures, including whether they are reasonably designed to ensure operational efficiency with other MFDA departments, specifically the functions in which Membership Services is involved (e.g. coordinating the review of applications for membership, re-organizations and resignations)
- the review and processing of membership requests, including communication with the applicable provincial regulatory staff regarding registration requests of an approved person and whether the review is timely
- monitoring and follow-up on terms and conditions of membership, late filing fees, and applicable exemptions/file waivers

In carrying out the above, Staff utilized the methodology set out in Appendix A.

Based on the work performed, Staff is satisfied that the MFDA has adequate processes in place to mitigate the key inherent risks Staff identified. However during the on-site examination work, Staff identified certain Enforcement processes, that were not within scope of the Review, that require further follow up with the MFDA.

## **C. Financial Operations**

As part of the annual risk assessment process, Staff determined that Financial Operations had a moderate adjusted risk score. However, because the oversight review methodology requires that each area be reviewed at least once in a 5-year cycle, Staff ensured that

mitigating controls were in place to prevent the following key inherent risks:

- inadequate budgeting methodology, whereby the annual funding requirement is not appropriate or capital projects are not evaluated on a reasonable basis and objectively prioritized
- inadequate processes in place to facilitate timely and appropriate reassessments of the fee allocation methodology
- inadequate processes in place to appropriately determine the valuation and manage the funded status of pension and other retirement benefit obligations

As a result, Staff's on-site examination work focused on assessing the adequacy of:

- budgeting methodology, especially concerning capital projects and annual funding requirements
- policies and procedures to facilitate timely and appropriate reassessments of the fee allocation methodology
- policies and procedures for determining valuation and managing the funded status of pension and other retirement benefit obligations

In carrying out the above, Staff utilized the methodology set out in Appendix A.

Based on the work performed, Staff is satisfied that the MFDA has adequate processes in place to mitigate the key inherent risks Staff identified.

Staff acknowledge that during the review period there was evidence that the MFDA discussed the need to reassess the current Dealer Member fee model and that the MFDA is considering a formal reassessment as part of its new Strategic Plan.

#### **D. Corporate Governance**

As part of the annual risk assessment process, Staff determined that Corporate Governance had a moderate adjusted risk score. However, because the oversight review methodology requires that each functional area be reviewed at least once in a 5-year cycle, Staff ensured that mitigating controls were in place to prevent the following key inherent risks:

- inadequate processes for approving disbursements and transfers from the Discretionary Fund
- inadequate Board training program and Board Code of Business Ethics and Compliance
- inadequate self-assessments by the Board and the Board Committees
- inadequate succession planning for the Board and the Board Committees
- inadequate diversity of representation, balance of interests, and independence from management on the Board and Board Committees

As a result, Staff's on-site examination work focused on assessing the adequacy of:

- the Discretionary Fund's<sup>5</sup> policies and procedures including whether they are reasonably designed to ensure its operation in the manner approved by the Board.
- the Board training program and Board Code of Business Ethics and Compliance including processes for addressing conflict of interest issues (e.g. sitting on boards of different organizations)
- policies and procedures for Board and Board Committee self-assessments which allow an assessment of performance and identification of areas for improvement
- policies and procedures for Board and Board Committee succession planning
- Board and Board Committee composition including diversity of representation, a balance of interests, and independence from management

In carrying out the above, Staff utilized the methodology set out in Appendix A.

Based on the work performed, Staff is satisfied that the MFDA has adequate processes in place to mitigate the key inherent risks Staff identified.

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<sup>5</sup> The MFDA maintains a separate fund, called the Discretionary Fund, which consists of fines imposed by MFDA hearing panels. This restricted fund may only be used for reasonable third party costs associated with enforcement hearings, funding the MFDA Investor Protection Corporation, and funding special projects that are beneficial to the public or Canadian capital markets. The use of this restricted fund must be authorized by the MFDA Board of Directors.



## APPENDIX A

### 1. Methodology

The Recognizing Regulators have adopted a risk-based methodology to determine the scope of the Review. On an annual basis, the Recognizing Regulators:

- identify the key inherent risks<sup>6</sup> of each functional area or key process based on:
  - reviews of internal MFDA documentation (including management self-assessments and risk assessments);
  - information received from the MFDA in the ordinary course of oversight activities (e.g. periodic filings, discussions with Staff);
  - the extent and prioritization of findings from the prior oversight review; and
  - the impact of significant events in or changes to markets and participants to a particular area
- evaluate known controls for each functional area
- consider relevant situational/external factors and the impact of enterprise wide risks on the MFDA as a whole or on multiple departments
- assign an initial overall risk score for each functional area
- collaborate with the MFDA to identify and assess the effectiveness of other mitigating controls that may be in place in specific functional areas
- assign an adjusted overall risk score for each area
- use the adjusted risk scores to determine the scope of the Review

Once the scope of the Review was determined, Staff conducted on-site examinations at the MFDA's Toronto, Calgary and Vancouver offices. These on-site examinations involved reviewing specific documents pertaining to the Review Period and interviewing appropriate MFDA staff in order to:

- confirm that mitigating controls were in place for the key inherent risks identified, and
- assess the adequacy and efficacy of those mitigating controls

### 2. Report Format

In keeping with a risk-based approach, this report focuses on those functional areas or key processes with higher risk.

### 3. Scope

Staff considered the status of the resolution of findings from prior oversight reviews and other issues that could impact the MFDA, and utilized the risk assessment process to identify specific processes and activities within the following above average risk area as the focus for the Review. There were no functional areas identified as high risk.

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<sup>6</sup> Inherent risk is the assessed level of the unrealized potential risk, taking into account the likelihood of and impact if the risk was realized prior to the application of any mitigating controls.

*Above Average*

- Sales Compliance

However, because each functional area must be examined at least once in a 5-year cycle, the following moderate risk areas were included within the scope of the Review:

*Moderate*

- Membership Services
- Financial Operations
- Corporate Governance

As well, through the risk assessment process, Staff determined that the following moderate risk areas would not be examined during the Review<sup>7</sup>:

*Moderate*

- Financial Compliance
- Enforcement
- Policy
- Information Technology
- Risk Management

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<sup>7</sup> The areas continue to be subject to oversight by the Recognizing Regulators through ongoing mandatory reporting by the MFDA as required by the ROs, as well as regularly scheduled and ad hoc meetings between the Recognizing Regulators and MFDA staff.

## **APPENDIX B**

### **Applicable Regulatory Requirements and Functions**

#### *Sales Compliance*

Term and Condition 7(A) of the ROs requires the MFDA to conduct periodic examinations of its members and Approved Persons to ensure compliance with MFDA rules.

#### *Membership Services*

Term and Condition 6 of the ROs requires that MFDA rules permit all properly registered mutual fund dealers who satisfy the membership criteria to become members. The criteria and processes for approving or denying membership must be fair, consistent, and reasonable.

Term and Condition 9 of the ROs requires the MFDA to ensure that the requirements regarding admission to membership, the imposition of limitations or conditions on membership, denial of membership and termination of membership are fair and reasonable.

#### *Financial Operations*

Term and Condition 2 of the ROs requires that the MFDA remain a not-for-profit corporation.

Term and Condition 4(A) of the ROs requires that fees imposed by the MFDA on its members be equitably allocated and bear a reasonable relation to the costs of regulating members, carrying out the MFDA's objects and protecting the public interest. Fees must not create unreasonable barriers to membership and must be designed to ensure sufficient revenues to discharge the MFDA's responsibilities.

Term and Condition 4(B) of the ROs requires that the MFDA's fee setting process be fair, transparent, and appropriate.

As part of its framework, the MFDA:

- is required to be a not-for-profit corporation and to manage its operations on a cost-recovery basis
- designated the Finance and Administration Department to monitor the financial operations and report to the Board's Audit and Financial Committee, which in turn reports to the Board at least quarterly
- derives fees from members as its key source of revenue
- maintains various types of corporate insurance policies

### *Corporate Governance*

Term and Condition 3 of the ROs sets out requirements for the composition of the MFDA's Board. The composition, and Board powers, as well as the powers and duties of directors and officers, are defined in MFDA By-law No. 1.

The MFDA endeavors to have governance practices that:

- result in a Board that
  - is diversified,
  - represents the public interest, and
  - is peopled by individuals who are fit and proper
- support high ethical standards and integrity
- require the review of the corporate governance model periodically to ensure that the model appropriately reflects changes in the Canadian capital markets including the mutual fund dealer industry
- ensure an appropriate governance system is in place for the Board's overall stewardship responsibility and the discharge of its obligations to MFDA stakeholders