MUTUAL FUND DEALERS ASSOCIATION OF CANADA

PROPOSED AMENDMENTS TO MFDA RULE 2.3.1(b)

(DISCRETIONARY TRADING)

I. OVERVIEW

A. Current Requirements

Currently, under MFDA Rule 2.3.1(b), no Member or Approved Person may engage in any discretionary trading.

B. Reasons for Amendments

As discussed in greater detail below, the proposed amendments are intended to be responsive to Member requests for regulatory flexibility, and would permit very limited discretionary trading in respect of mutual fund model portfolios offered by Members.

C. Objectives

The objectives of the proposed amendments are to allow Members to engage in limited discretionary trading, so that they are able to directly perform fund substitutions, and make changes to portfolio asset allocations within the pre-established parameters of the mutual fund model portfolios offered by them.

D. Effect of Proposed Amendments

The effect of the proposed amendments, will be to improve client service, and reduce regulatory burden, while maintaining or enhancing investor protection.

II. DETAILED ANALYSIS

A. Proposed Amendments

Background

Model Portfolios

Model portfolio programs require clients to first complete an investor questionnaire, which collects Know-Your-Client (KYC) information. The KYC information collected for a client is used to categorize that client into one of several client profiles or risk categories. The client is then placed into the pre-established model portfolio which best corresponds to their profile/risk category. All clients that fall within a particular profile/risk category are recommended the same model portfolio of mutual funds. These model portfolios are monitored, and subject to periodic rebalancing.

Existing Arrangements

Members offer model portfolios to clients in different ways, including through dealer or fund-company administered programs.

In dealer administered programs, dealers create the mutual fund model portfolios and perform rebalancing transactions. Such rebalancing is done within the pre-established parameters of the portfolio and at a frequency that is agreed to by the client when entering into the program[1]. However, mutual fund dealers are limited in that they cannot make fund substitutions, or changes to portfolio asset allocations without first obtaining client authorization.

Reason for Proposed Amendments

Over the past year, Members have requested that they be given the ability to directly make certain changes to their dealer administered programs, for the purpose of increasing efficiencies and providing better service to clients (i.e. dealers seek to achieve such objectives without having to engage the services of an external portfolio manager, or go through an exemptive relief process).

Specifically, as noted, regulatory flexibility has been sought to enable dealers to make fund substitutions and limited changes to portfolio asset allocations on a discretionary basis (i.e. without first having to obtain authorization from every client in the model portfolio). This is currently not possible under MFDA Rules, as Rule 2.3.1(b) prohibits Members and Approved Persons from engaging in any discretionary trading.

MFDA staff is of the view that Members have raised valid arguments in support of their position, and that requests for regulatory flexibility in respect of this matter can be accommodated while preserving investor protection, enhancing service to clients, and reducing regulatory burden.

In developing the proposed amendments set out below, staff has taken a number of factors into consideration, including the following:

- **Better client service:** Members have noted that having the ability to engage in limited discretionary trading, in the manner requested, would allow them to provide more efficient service to clients and a better model portfolio solution, as dealers would be able to respond, in a more timely manner, to such things as underperforming funds or rapidly changing market conditions;

- **Reduced regulatory burden:** if a Member does not have the ability to directly make fund substitutions or changes in asset allocation in respect of the mutual fund model portfolios which it offers, then it will either have to: (1) establish a separate legal entity (i.e. a new portfolio manager registrant) outside of the mutual fund dealer to perform the very limited discretionary trading associated with such activities; or (2) engage the services of an external portfolio manager to conduct such activities on its behalf. In the view of MFDA staff, no added investor protection would be achieved by requiring the Member to take either of these steps. If a Member is permitted to become registered as a portfolio manager and directly engage in limited discretionary trading, for the purposes identified, the

[1] See MFDA Staff Notice MSN-0084 – *Advance Instructions for Account Rebalancing.*

Member will be able to achieve its objectives in a more streamlined manner, and reduce its regulatory burden while maintaining investor protection;

- **Investor protection would not be compromised:** in the view of MFDA staff, the proposed amendments would not compromise existing investor protections, as discretionary trading would only be permitted in the very limited circumstances discussed below;

- **Investor protection could be enhanced:** under the proposed amendments, all regulatory requirements and obligations to clients would rest with one mutual fund dealer registrant, as opposed to being shared between a dealer and an external portfolio manager. This approach would allow for the avoidance of potential disputes between different parties as to who is responsible and liable to the client in any particular situation;

- **Standard of Care:** under the proposed amendments, the MFDA Member would be subject to a portfolio manager standard of care in respect of any discretionary trading done in the model portfolio(s) in which the client was invested (i.e. such a standard of care would apply whether the discretionary trading was performed by a single legal entity (i.e. MFD/restricted PM), a separate PM established by the Member, or an external PM);

- **Dealing with multiple fund companies:** where a dealer sells the model portfolio of a particular fund company, it is limited to the products of that fund company when making fund substitutions. If dealers had the ability to directly make fund substitutions (i.e. within the pre-established parameters of the model portfolio), they would be free to choose from a wider variety of products from different fund companies.

Summary of Proposed Amendments

The following is a summary of proposed amendments to Rule 2.3.1(b). Attached as Schedule "A" to this Notice, is a blackline of the Rule, which shows proposed amendments to reflect the revisions noted below.

Proposed amendments to Rule 2.3.1(b) would permit discretionary trading only where:

(i) the Member and any Approved Person engaged in discretionary activity on its behalf is appropriately registered under securities legislation to provide discretionary portfolio management services, or has received an exemption from the requirement for such registration from the securities regulatory authority/authorities having jurisdiction; and

(ii) discretionary trading is limited to mutual funds (i.e. those securities in which the Member is already licensed to trade under the mutual fund dealer category of registration) that are part of a model portfolio offered by the Member.

In addition, and pursuant to requirements under MFDA Rule 2.10 (Policies and Procedures Manual), Members would be required to establish and maintain written policies and procedures to ensure that such discretionary trading complies with MFDA By-laws, Rules, and Policies, and any applicable requirements under securities legislation.

As noted, the proposed amendments would require Members and Approved Persons to be registered to provide discretionary portfolio management services, or to obtain an exemption from such requirements. The MFDA will work collaboratively with the CSA to ensure that there is appropriate regulatory oversight in respect of any discretionary activity undertaken by Members.

MFDA Rule 2.2.5 (Relationship Disclosure)

Currently, under Rule 2.2.5(a), a Member's relationship disclosure to clients must include a brief description of the nature of the advisory relationship and how it operates. This subsection of the Rule would be revised to additionally require a description of the extent of the discretionary authority which is being exercised by the Member (e.g. that it is limited to making fund substitutions, and changes to asset allocations within the pre-established parameters of the mutual fund model portfolio in which the client is invested). Attached, as Schedule "B" to this memo is a blackline of Rule 2.2.5 which shows amendments to reflect the revisions referenced above.

B. Comparison with Similar Provisions

During the development of the proposed amendments, consideration was given to Rule 1300.7(a)(i) of the Investment Industry Regulatory Organization of Canada ("IIROC"), under which an IIROC dealer member may exercise discretionary authority in respect of a managed account, provided that the individual responsible for the management of the account is a portfolio manager. Proficiency requirements for IIROC Registered Representatives who provide such discretionary portfolio management are set out under IIROC Rule 2900 and are similar to proficiency requirements for Portfolio Manager – advising representatives, as prescribed under Part 3.11 of National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (NI 31-103).

The ability to exercise discretionary authority with respect to a managed account, as available under IIROC Rule 1300.7, does not require the dealer, itself, to become registered as a portfolio manager under securities legislation, or require that the dealer engage a third party portfolio manager for the provision of such services.

The proposed amendments are intended to achieve, on a more limited basis, what is already permitted for IIROC dealer members under IIROC rule 1300.7. The proposed amendments would be more restrictive in that:

- the MFDA dealer Member would be required to become appropriately registered under securities legislation to provide discretionary portfolio management services (i.e. as a restricted portfolio manager, where discretionary trading activities are limited to transactions in mutual funds), or have received an exemption from the requirement for such registration; and

- the discretionary trading available to the Member would be limited to fund substitutions, and changes to portfolio asset allocations, within the pre-established parameters of the mutual fund model portfolios offered by the Member.

C. Issues and Alternatives Considered

Several exemptions have been granted in connection with the proposed distribution to clients of mutual fund model portfolio products offered by dealers. Guidance in respect of these

arrangements is set out in OSC Staff Notice 81-708 - *Model Portfolios of Mutual Funds* (published May, 2006).

Prior to the development of the proposed amendments, consideration was given to not pursuing any changes to Rule 2.3.1(b), and instead requiring Members to apply for and seek to rely upon the existing exemptive relief referenced above. However, such an approach would unnecessarily add costs and regulatory burden, not be responsive to Member requests for regulatory flexibility, which MFDA staff regard as reasonable and consistent with investor protection, and would also not be in line with the MFDA's goal of supporting responsible innovation in the industry.

For example, Members able to rely on existing relief (i.e. those with an affiliated portfolio manager, or who have engaged an external portfolio manager) would still have to prepare, and file a formal exemption application, respond to CSA requests for information, and wait for the CSA members having jurisdiction to review the application and come to a determination in respect of the matter (i.e. even taking advantage of existing relief would involve the assumption of added costs, time, and regulatory burden).

Members who are not eligible to rely on existing relief would have to either establish a separate portfolio manager outside of the Member, or engage a third party portfolio manager for the purposes of performing the limited discretionary trading associated with making fund substitutions and/or changes to portfolio asset allocations in connection with the mutual fund model portfolios offered by them.

In the view of MFDA staff, and as noted above, continuing to require Members to assume such regulatory burdens to engage in very limited discretionary trading (i.e. which would be confined to mutual funds, and further limited to transactions within the pre-established parameters of the mutual fund model portfolio offered by the Member), would not result in any enhancement to investor protection, or give rise to any other corresponding benefits.

D. Systems Impact of Amendments

It is not anticipated that the proposed amendments will have a material impact upon Members' systems, impose any material burden or constraint on competition or innovation, impose any material costs or restrictions on the activities of market participants, or result in any material increased costs of compliance.

E. Best Interests of the Capital Markets

The proposed amendments to Rule 2.3.1(b) were approved by the MFDA Board of Directors at their February 27, 2019 meeting. The Board has determined that the proposed amendments are consistent with the best interests of the capital markets.

F. Public Interest Objective

The proposed amendments will improve client service, reduce regulatory burden, maintain or enhance investor protection, and are consistent with the public interest.

G. Classification

The proposed amendments have been classified as Public Comment Rule proposals.

III. COMMENTARY

A. Filing in Other Jurisdictions

The proposed amendments will be filed for approval with the Alberta, British Columbia, Manitoba, Nova Scotia and Ontario Securities Commissions, the New Brunswick Financial and Consumer Services Commission, the Superintendent of Securities of Prince Edward Island, and the Saskatchewan Financial and Consumer Affairs Authority.

B. Effectiveness

The proposed amendments are simple and effective.

C. Process

The proposed amendments were reviewed and approved by the MFDA Policy Advisory Committee at its January 31, 2019 meeting, the Regulatory Issues Committee of the MFDA Board of Directors at its February 13, 2019 meeting, and by the full MFDA Board of Directors at its February 27, 2019 meeting. In approving the proposed amendments, the MFDA has followed its established internal governance practices and has considered the need for consequential amendments.

D. Effective Date

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

E. Exemption from Requirements under Securities Legislation

The proposed amendments do not involve a Rule that the MFDA, its Members or Approved Persons must comply with in order to be exempted from a securities legislation requirement.

F. Conflict with Applicable Laws or Terms and Conditions of Recognition Order

The proposed amendments do not conflict with applicable laws or the Terms and Conditions of a Recognizing Regulator's Recognition Order.

IV. SOURCES

- MFDA Rule 2.3.1(b) (Discretionary Trading);
- MFDA Rule 2.2.5 (Relationship Disclosure);
- IIROC Rule 1300 (Supervision of Accounts);
- IROC Rule 2900 (Proficiency and Education);
- OSC Staff Notice 81-708 – *Model Portfolios of Mutual Funds*
- National Instrument 31-103 – *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, Part 3 (Registration Requirements – Individuals).

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 within 120 days of the publication of this notice, addressed to the attention of:

Paige Ward
General Counsel, Corporate Secretary and Vice-President, Policy
Mutual Fund Dealers Association of Canada
121 King St. West, Suite 1000
Toronto, Ontario M5H 3T9
pward@mfda.ca

and one copy addressed to the attention of:

Anne Hamilton
Senior Legal Counsel
British Columbia Securities Commission
701 West Georgia Street
P.O. Box 10142, Pacific Centre
Vancouver, British Columbia, V7Y 1L2
ahamilton@bcsc.bc.ca

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:

Paige Ward
General Counsel, Corporate Secretary and
Vice-President, Policy
Mutual Fund Dealers Association of Canada
(416) 943-5838

DM#662035

Schedule "A"

Proposed Amendments to Rule 2.3.1(b)

2.3 CONTROL OR AUTHORITY

2.3.1 (b) Discretionary Trading

No Member or Approved Person shall engage in any discretionary trading.

(b.1) Notwithstanding the provisions of paragraph (b), a Member may engage in discretionary trading provided that:

(i) the Member and any Approved Person engaged in discretionary trading on its behalf is appropriately registered under securities legislation to provide discretionary portfolio management services, or has received an exemption from the requirement for such registration by the securities regulatory authority/authorities having jurisdiction; and

(ii) discretionary trading engaged in by the Member is limited to mutual fund securities that are part of a mutual fund model portfolio offered by the Member.

Schedule "B"

Proposed Amendments to Rule 2.2.5

2.2.5 Relationship Disclosure

For each new account opened, the Member shall provide written disclosure to the client:

(a) describing the nature of the advisory relationship and, in the case of an account where discretionary authority is being exercised pursuant to Rule 2.3.1(b), a description of the extent of the discretionary authority being exercised;

(b) describing the products and services offered by the Member;

(c) describing the Member's procedures regarding the receipt and handling of client cash and cheques. In the case of a Level 2 dealer, the disclosure must include an explanation that all client cheques shall be payable to the issuer or carrying dealer, as applicable;

(d) describing the Member's obligation to ensure that each order accepted or recommendation made for any account of a client is suitable for the client in accordance with Rule 2.2.1 and advising when the Member will assess the suitability of the investments in the client's account;

(e) defining the various terms with respect to the know-your-client information collected by the Member and describing how this information will be used in assessing investments in the account;

(f) describing the content and frequency of reporting for the account;

(g) describing the nature of the compensation that may be paid to the Member and referring the client to other sources for more specific information;

(h) describing the type of transaction charges, as defined under Rule 5.3(1), that the client might be required to pay; and

(i) including a general explanation of how investment performance benchmarks might be used to assess the performance of a client's investments and any options for benchmark information that might be available to clients by the Member.

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