

13.1.2 Housekeeping Amendments to MFDA Rule 3 – Financial and Operations Requirements

MUTUAL FUND DEALERS ASSOCIATION OF CANADA

HOUSEKEEPING AMENDMENTS TO MFDA RULE 3

(FINANCIAL AND OPERATIONS REQUIREMENTS)

Current Rule

Rule 3 sets out the minimum requirements that MFDA Members must observe regarding financial and operational considerations. These include minimum Member capital, segregation of client property, early warning provisions, financial filings and audit requirements.

In particular, Rule 3.5.3 requires Members to file, through their auditors, on an annual basis, such additional information relating to affairs of any related Members, as considered necessary by the MFDA.

Reasons for Amendments

Most of the amendments to Rule 3 have been proposed to clarify, update and address minor inconsistencies between terms used in the Rule and terms used in other contexts, such as the Canadian Institute of Chartered Accountants (“CICA”) Handbook.

With respect to Rule 3.5.3, this Rule was initially included prior to the establishment of the MFDA Investor Protection Corporation. The Rule contemplated cases where there may be companies that are considered “related” and are both covered by the MFDA’s investor protection fund, but are not both subject directly to the MFDA’s audit jurisdiction. Given the fact that the MFDA Investor Protection Corporation only offers coverage to Members of the MFDA, Rule 3.5.3 is no longer considered relevant.

Description of Amendments

The following amendments to Rule 3 are proposed:

- MFDA Investor Protection “Fund” or “Plan” has been changed to MFDA Investor Protection “Corporation” (Rules 3.4.2(b)(ii)(C), 3.6.5 and 3.6.7).
- The word “inventory” has been changed to “investments” to more accurately state the Rule as mutual fund dealers do not typically have “inventory” balances (Rule 3.4.3).
- The word “consolidated” has been changed to “combined” as “consolidated” is a defined term under the CICA Handbook whereas the MFDA reporting requirements are specifically outlined in the Rule (Rule 3.5.2).
- Rule 3.5.3 has been deleted.
- The word “Canadian” has been added where there are specific references to “generally accepted accounting principles” or “generally accepted auditing standards” to clarify that it is Canada’s standards that apply (Rules 3.5.4(b) and 3.6.1).
- Specific references to the CICA Handbook have been removed as section references have become outdated (Rules 3.6.2(a), 3.6.2(a)(i), 3.6.2(a)(ii) and 3.6.4).
- Early warning “reserves” has been changed to early warning “excess” to ensure consistency of terms used (Rule 3.6.2(a)(ii)).
- The word “prove” has been changed to “substantiate” to more accurately state the auditor requirements and ensure consistency with CICA Handbook terminology (Rule 3.6.2(b)(i)).
- Where terms are narrow in scope (i.e. “mutual fund”, “security”), amendments have been made to clarify the requirement is broader in scope. For example, “securities” has been changed to “securities or other investment products” or “assets” to ensure that guaranteed investment certificates and other products are considered (Rules 3.6.2(b)(iii), 3.6.2(b)(v), 3.6.2(b)(vi)(B) and 3.6.2(b)(iv)(C)).
- Specific Rules have been updated to properly reflect changes in auditing practices resulting from advancements in technology over time (Rules 3.6.2(b)(iv) and 3.6.2(b)(vi)).

SRO Notices and Disciplinary Proceedings

- Additional wording has been added for clarification of specific requirements (Rules 3.6.2(b)(v) and 3.6.2(b)(vi)(B)).
- Corrections have been made to cross-references (e.g. changing “(E)” to “(D)”) (Rule 3.6.2(b)(vi)).
- The words “Cash and” have been added to the Rule to reflect the proper name of the Report in Form 1 (Rule 3.6.2(b)(ix)).

The proposed amendments are housekeeping in nature in that they are intended to clarify existing requirements and the current language of the Rule.

Effective Date

The amended Rule will be effective on a date to be subsequently determined by the MFDA.

MUTUAL FUND DEALERS ASSOCIATION OF CANADA

FINANCIAL AND OPERATIONS REQUIREMENTS (Rule 3)

On May 22, 2008, the Board of Directors of the Mutual Fund Dealers Association of Canada made the following housekeeping amendments to MFDA Rule 3:

3.4 EARLY WARNING

3.4.2 (b) **Requirements.** If a Member is designated in early warning then, notwithstanding the provisions of any By-law or Rule, the following provisions shall apply:

(ii) the Corporation shall immediately designate the Member as being in early warning and shall deliver to the chief executive officer and chief financial officer a letter containing the following:

- (A) advice that the Member is designated as being in early warning,
- (B) a request that the Member file its next monthly financial report required pursuant to Rule 3.5.1(a) no later than 15 business days or, in the discretion of the Corporation if considered to be practicable, such earlier time following the end of the relevant month,
- (C) a request that the Member respond to the letter as required under Rule 3.4.2(b)(iii) and confirmation that such response, together with the notice received pursuant to Rule 3.4.2(b)(i), will be forwarded to MFDA Investor Protection ~~Fund~~ Corporation and may be forwarded to any securities commission having jurisdiction over the Member,
- (D) advice that the restrictions referred to in Rule 3.4.2(b)(iv) shall apply to the Member,
- (E) such other information as the Corporation shall consider relevant;

3.4.3 **Restrictions.** The Corporation may in its discretion, without affording the Member a hearing, prohibit a Member which is designated as being in early warning from opening any new branch offices, hiring any new Approved Persons, opening any new client accounts or changing in any material respect the ~~inventory~~ investment positions of the Member. Any such prohibitions which have been imposed shall continue to apply until the Member is no longer designated as being in early warning, as demonstrated by the latest filed monthly financial report of the Member.

3.5 FILING REQUIREMENTS

3.5.2 ~~Consolidated~~ **Combined Financial Statements.** In calculating the risk adjusted capital of a Member, the financial position of the Member may, with the prior approval of the Corporation, be ~~consolidated~~ combined (in a manner as set out below) with that of any related Member provided that:

- (a) the Member has guaranteed the obligations of such related Member and the related Member has guaranteed the obligations of the Member (such guarantee to be in a form acceptable to the Corporation and unlimited in amount).
- (b) inter-company accounts between the Member and the related Member shall be eliminated;
- (c) any minority interests in the related Member shall be eliminated from the capital calculation; and
- (d) calculations with respect to the Member and the related Member shall be as of the same date.

~~3.5.3 Related Members. In addition to the statements under Rule 3.5.1, each Member shall file annually with the Corporation through the Member's auditor, particulars of the name and relationship to the Member of each related Member and such financial statements and reports with respect to the affairs of any such related Member as the Corporation considers necessary or advisable.~~

~~3.5.4~~ 3.5.3 **Members' Auditors**

- (b) **Standards.** The Member's auditor shall conduct his or her examination of the accounts of the Member in accordance with Canadian generally accepted auditing standards and the scope of his or her procedures shall be sufficiently extensive to permit him or her to express an opinion on the Member's financial statements in

the form prescribed. Without limiting the generality of the foregoing, the scope of the examination shall, where applicable, include at least the procedures set out in Rule 3.6.

~~3.5-53.5.4~~ **Assessments**

3.6 AUDIT REQUIREMENTS

3.6.1 **Standards.** The audit under Rule 3.5 shall be conducted in accordance with Canadian generally accepted auditing standards and shall include a review of the accounting system, the internal accounting control and procedures for safeguarding assets. It shall include all audit procedures necessary under the circumstances to support the opinions which must be expressed in the Member's auditor's reports of Parts I and II of Form 1. Because of the nature of the industry, the substantive audit procedures relating to the financial position must be carried out as of the audit date and not as of an earlier date, notwithstanding that the audit is otherwise conducted in accordance with Canadian generally accepted auditing standards.

3.6.2 **Scope**

(a) *Tests.* The scope of the audit shall include the following procedures, but nothing herein shall be construed as limiting the audit or permitting the omission of any additional audit procedure which any Member's auditor would deem necessary under the circumstances. For purposes of this Rule tests fall into two basic categories (as described in CICA Handbook ~~sections 5300.11 to 5300.24~~):

- (i) specific item tests, whereby the auditor examines individual items which he or she considers should be examined because of their size, nature or method of recording (~~CICA Handbook Section 5300.13~~); and
- (ii) representative item tests, whereby the auditor's objective is to examine an unbiased selection of items (~~Section 5300.13~~).

The determination of an appropriate sample on a representative basis may be made using either statistical or non-statistical methods in accordance with Canadian generally accepted auditing standards (~~CICA Handbook Section 5300.14~~).

In determining the extent of the tests appropriate in sub-sections (i), (ii) and (iii) of (b) below, the Member's auditor should consider the adequacy of the system of internal control and the level of materiality appropriate in the circumstances so that in the auditor's professional judgement the risk of not detecting a material misstatement, whether individually or in aggregate is reduced to an appropriately low level (e.g. in relation to the estimated risk adjusted capital and early warning ~~reserves excess~~).

(b) *Audit Procedures.* The Member's auditor shall as of the audit date:

- (i) compare ledger accounts with the trial balances obtained from the general and subsidiary ledgers and ~~prove~~ substantiate the subsidiary ledger totals with their respective control accounts (see Rule 3.6.4 below relating to Electronic Data Processing);
- (ii) account for, by physical examination and comparison with the books and records, all securities in the physical possession of the Member;
- (iii) review the reconciliation of all mutual funds companies and financial institutions where a Member operates a nominee name account and review the balancing of all security positions. Where a position or account is not in balance according to the records, ascertain that an adequate provision has been made in accordance with the Notes and Instructions for out of balance positions embodied in Statement B of Form 1 for any potential loss;
- (iv) review bank reconciliations. ~~After allowing at least ten business days to elapse, obtain bank statements, cancelled cheques and all other debit and credit memos directly from the banks and by appropriate audit procedures substantiate on a test basis the reconciliations with the ledger control accounts as of the audit date;~~
- (v) where a Member operates a nominee name account or has its own securities or investment products, ensure that all custodial agreements are in place for securities ~~those~~ lodged with acceptable locations and that such agreements satisfy the minimum requirements of the Corporation;

- (vi) obtain written confirmation with respect to the following:
 - (A) bank balances and other deposits;
 - (B) cash, ~~nominee name security~~ positions and deposits with clearing houses and like organizations and cash and ~~nominee name security~~ positions with mutual fund companies and financial institutions;
 - (C) cash and ~~securities investments~~ loaned or borrowed (including subordinated loans) together with details of collateral received or pledged, if any;
 - (D) accounts with brokers or dealers;
 - (E) accounts of directors, partners or officers of the Member held by the Member where the Member operates a nominee name account;
 - (F) accounts of clients where a Member operates a nominee name account;
 - (G) statements from the Member's lawyers as to the status of lawsuits and other legal matters pending which, if possible, should include an estimate of the extent of the liabilities so disclosed; and
 - (H) all other accounts which in the opinion of the Member's Auditor should be confirmed.

Compliance with the confirmation requirements shall be deemed to have been made if positive requests for confirmation have been ~~mailed sent by, and returned directly to,~~ the Member's auditor ~~in an envelope bearing the auditor's return address~~ and second requests are similarly ~~mailed sent~~ to those not replying to the initial request. Appropriate alternative verification procedures must be used where replies to second requests have not been received. For accounts mentioned in ~~(D)~~ and (F) above, the Member's auditor shall (1) select specific accounts for positive confirmation based on their size (all accounts with equity exceeding a certain monetary amount, with such amount being related to the level of materiality) and other characteristics such as accounts in dispute ~~and nominee name accounts~~, and (2) select a representative sample from all other accounts of sufficient extent to provide reasonable assurance that a material error, if it exists, will be detected. For accounts in ~~(D)~~ and (F) above that are not confirmed positively, the Member's auditor shall ~~mail send~~ statements with a request that any differences be reported directly to the auditor. Clients' accounts without any balance whatsoever and those closed since the last audit date shall also be confirmed on a test basis using either positive or negative confirmation procedures, the extent to be governed by the adequacy of the system of internal control;

- (vii) subject the Statements in Part I and Schedules in Part II of Form 1 to audit tests and/or other auditing procedures to determine that the margin and capital requirements, which are used in the determination of the excess (deficiency) of risk adjusted capital are calculated in accordance with the Rules and Form 1 in all material respects in relation to the financial statements taken as a whole;
- (viii) obtain a letter of representation from the senior officers of the Member with respect to the fairness of the financial statements including among other things the existence of contingent assets, liabilities and commitments;
- (ix) complete and report on the results of applying the prescribed procedures contained in the Report on Compliance for Segregation of Cash and Securities in Form 1.

3.6.3 ~~Insurance and Subsequent Events~~ **Additional Reporting.** In addition, the Member's auditor shall:

- (a) complete and report on the results of applying the prescribed procedures contained in the Report on Compliance for Insurance in Form 1; and
- (b) report on any subsequent events, to date of filing, which have had a material adverse effect on the excess (deficiency) of risk adjusted capital.

3.6.4 **Systems Review.** The Member's auditors' review of the accounting system, the internal accounting control and procedures for safeguarding securities prescribed in the above Audit Requirements should encompass any in-house or service bureau EDP operations. ~~(This may include reliance on CICA Handbook Section 5900 report "Opinions on Control Procedures at a Service Organization").~~ As a result of such review and evaluation the Member's auditor may

be able to reduce the extent of detailed checking of clients and other account statements to trial balances and security position records.

- 3.6.5 **Retention.** Copies of Form 1 and all audit working papers shall be retained by the Member's auditor for seven years. The two most recent years shall be kept in a readily accessible location. All working papers shall be made available for review by the Corporation and the MFDA Investor Protection ~~Plan~~Corporation and the Member shall direct its auditor to provide such access on request.
- 3.6.7 **Reliance.** The reports and audit opinions required in respect of a Member under this Rule 3.6 shall be addressed to the Corporation and the MFDA Investor Protection ~~Plan~~Corporation in conjunction with the Member who shall be entitled to rely on them for all purposes.