

Chapter 13

SROs, Marketplaces and Clearing Agencies

13.1 SROs

13.1.1 MFDA Rule 2.4.4 and Amendments to MFDA Rule 5.1 Regarding Transaction Fees or Charges and Requirement for Records – Notice of Commission Approval

MUTUAL FUND DEALERS ASSOCIATION OF CANADA (MFDA)

MFDA RULE 2.4.4 AND AMENDMENTS TO MFDA RULE 5.1 REGARDING TRANSACTION FEES OR CHARGES AND REQUIREMENT FOR RECORDS

NOTICE OF COMMISSION APPROVAL

The Ontario Securities Commission has approved MFDA Rule 2.4.4 and amendments to MFDA Rule 5.1 regarding the disclosure of transaction fees or charges and the record keeping requirements in relation to transaction fees or charges. In addition, the British Columbia Securities Commission approved and the Alberta Securities Commission, the Saskatchewan Financial Services Commission, the Manitoba Securities Commission, the New Brunswick Securities Commission and the Nova Scotia Securities Commission did not object or not disapprove the MFDA's proposal.

The new rule and amendments provide minimum standards for members' obligations to inform investors of transaction fees or charges prior to the acceptance of their order. Members will also be required to maintain records evidencing that the client was informed of all fees and charges in accordance with the new MFDA Rule 2.4.4.

The MFDA's proposal was published for comment on June 25, 2010 at (2010) 33 OSCB 5969. The MFDA summarized the comments it received on the proposal and provided responses. A summary of the comments and MFDA responses is included below.

**SUMMARY OF PUBLIC COMMENTS
RESPECTING REQUEST FOR COMMENT ON
PROPOSED NEW MFDA RULE 2.4.4 (TRANSACTION FEES OR CHARGES) AND
PROPOSED AMENDMENTS TO MFDA RULE 5.1 (REQUIREMENT FOR RECORDS)**

On June 25, 2010, the British Columbia Securities Commission published proposed new MFDA Rule 2.4.4 (Transaction Fees or Charges) and proposed amendments to MFDA Rule 5.1 (Requirement for Records) (the “**Proposed Amendments**”) for a 90-day public comment period that expired on September 23, 2010.

6 submissions were received during the public comment period:

1. Canadian Foundation for Advancement of Investor Rights (“FAIR”)
2. Desjardins
3. IGM Financial (“IGM”)
4. The Investment Funds Institute of Canada (“IFIC”)
5. Kenmar Associates (“Kenmar”)
6. Primerica Financial Services Limited (Canada) (“PFSL”)

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

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

1. General Comments

Kenmar and FAIR expressed support for the Proposed Amendments. Kenmar indicated that it has also received a significant number of complaints similar to those outlined in the Publication Notice. In addition, Kenmar noted related suitability issues, including the sale of DSC funds in Registered Retirement Income Funds (“RRIFs”) and to individuals over 75 years of age, the sale of money market DSC funds where a client’s time horizon was known to be months or weeks, and exposure to capital gains tax when funds are sold towards the calendar year end. FAIR expressed the view that it is essential that investors be provided with complete information with respect to fees and charges prior to execution of a transaction, both at the time of initial trade and at redemption, and expressed strong support for the objective of ensuring that redemption fees and charges are properly disclosed prior to a firm’s acceptance of any redemption order.

IFIC and PFSL expressed support for the objectives and intent of the Proposed Amendments, while raising operational and financial concerns.

IGM and Desjardins also raised operational and financial concerns, but were of the view that the Proposed Amendments should not proceed. IGM expressed the view that the Proposed Amendments ignore that the specific interaction with clients in a particular case and the documenting of the nature and content of the contact is dependant upon the facts. IGM further stated that the difficulty with the approach taken in the Rule change, with its sweeping scope, is that it does not reflect these considerations. IGM and Desjardins were also of the view that, depending upon the full implications of the proposed changes, there is a high likelihood that these requirements could cause interruptions in the flow of transactions desired by clients and prevent them from occurring in a timely fashion.

Desjardins expressed the view that the current regulation with respect to fee disclosure is sufficient, noting that an Approved Person who fails to discuss fees with a client is not fulfilling his or her responsibilities to the client and does not comply with existing Rules with respect to general business conduct, Know-Your-Client and Know-Your-Product. Desjardins commented that, with respect to such Approved Persons, the issue is non-compliance rather than deficient regulation and the Proposed Amendments are unlikely to affect it. Desjardins recommended that, rather than proceeding with the Proposed Amendments, the MFDA, in a Member Regulation Notice, provide examples of complaints it received with respect to fee disclosure and clarify what constitutes inappropriate conduct, as well as provide guidance with respect to fee disclosure when the Client Relationship Model amendments become effective. PFSL indicated that more industry consultation is required prior to the implementation of the Proposed Amendments.

PFSL suggested that clients should be counseled to ask for an estimate of potential sales charges at the time they are considering selling their funds and that their representatives are willing to providing such information upon request. Desjardins referenced similar regulations of the United Kingdom Financial Services Authority (“FSA”), and noted that the FSA regulation mandates disclosure only if requested by the client.

MFDA Response

Staff acknowledges comments supporting the Proposed Amendments and notes that there is currently no requirement under MFDA Rules to provide fees and charges disclosure at the time of the transaction. When the issue of disclosure of transaction fees or charges has arisen in the context of client complaints, Members have often stated that there is no regulatory obligation to provide this disclosure under current MFDA Rules. Member Regulation Notice MR-0035 – *Recording and Maintaining Evidence of Client Trade Instructions* clarifies requirements under Rule 5.1(b) and *recommends*, as a best practice, that the record of client instructions include confirmation as to the discussion regarding fees or charges that will or may apply on the transaction.

With respect to comments raising operational and financial concerns, staff notes, generally, that the Proposed Amendments codify *existing* industry practice and are intended to address the significant number of investor complaints received where investors have advised staff that they were not informed of fees and charges resulting from a particular transaction prior to the acceptance of their order and only became aware of such information when they received their trade confirmation or account statement.

The basic objective of the Proposed Amendments is to assist investor decision making through the timely provision of information and not to impair the timely execution of client transactions. The disclosure required under Rule 2.4.4 is intended to give clients a *reasonable* idea of fees and charges that will apply at the time of the transaction. In meeting the requirements of Rule 2.4.4, Members and Approved Persons are expected to act reasonably and in the best interests of clients, and provide the most current and accurate information in respect of fees and charges that can be reasonably provided in the circumstances. Further, we note that the requirements of the Proposed Amendments may be satisfied *either* through the provision of a document or by having a discussion with the client.

With respect to allowing fees and charges information to be provided on request, staff notes that clients who are counseled in advance to ask for such information on future transactions may not subsequently remember to do so. Accordingly, given the importance of fees and charges information to client decision making, it is appropriate to require its disclosure at the time of the transaction.

The Proposed Amendments have a clear regulatory objective and respond to a clearly identified regulatory need that is based on numerous client complaints received in respect of the particular issue. Moreover, as noted, the Proposed Amendments do not introduce novel requirements, but rather codify and standardize *existing* industry practice.

These matters will be clarified in a forthcoming companion Member Regulation Notice.

2. Specific Comments

Provision of Fee Disclosure More Appropriate at Time of Purchase

IFIC and PFSL expressed the view that a disclosure and discussion of fees is most valuable to the investor at the time that he or she is purchasing their mutual fund units. PFSL was of the view that most complaints related to sales charges are caused by a failure to understand such charges at the time of purchase rather than by an absence of disclosure at the time investments are being redeemed. IFIC added that the disclosure of redemption fees at the time of a switch or redemption will not assist investors in selecting a fee structure, as that decision has been made with full disclosure at the time of purchase.

MFDA Response

The disclosure and discussion of fees and charges at the time of purchase is valuable to clients the Proposed Amendments are intended to complement such disclosure. However, clients typically have multiple interactions with their advisors over time and may not remember a meeting or conversation in which such fees were discussed. In addition, as clients often purchase a combination of products to which different fees or charges may apply, they may not recall the fees and charges that apply to a specific product. Where a significant period of time has elapsed between a client's purchase of mutual fund units and their next transaction in the account (e.g. transfer or redemption request), investors may have forgotten the point of sale disclosure, or may not recall it in sufficient detail to meaningfully inform their present decision making and, as noted, may not remember to ask what the fees and charges associated with their present transaction are prior to the transaction. This position is supported by the number of investor complaints that have been received on this issue *and* the fact that the proposed disclosure is already provided as an industry practice.

Proposed Amendments are Duplicative of Existing and Proposed Requirements

Desjardins, IFIC, IGM and PFSL noted that a highly regulated framework already exists for the sale of mutual funds and referenced:

- Existing and proposed suitability requirements and other Member and Approved Person obligations under securities legislation and self-regulatory organizations' Rules, including the Client Relationship Model amendments, prospectus requirements that prescribe full, true and plain disclosure of all material facts related to a particular mutual fund, as well as information in respect of risks related to the investment, objectives and fees; and
- The Canadian Securities Administrators' ("CSA") proposed Point of Sale amendments to National Instrument 81-102 *Mutual Funds* ("NI 81-102"), including the proposed Fund Facts document.

IFIC was of the view that the MFDA should wait to assess the impact of the CSA Point of Sale project rather than introducing overlapping and potentially inconsistent regulation.

FAIR disagreed with the view that the current regulatory structure sufficiently addresses the intended objective of the Proposed Amendments, noting that MFDA Members can offer products that are not necessarily covered by the CSA Point of Sale initiative, which is aimed at indirect fees and charges and does not contemplate such disclosure on redemption.

MFDA Response

The Proposed Amendments were developed with consideration of existing and proposed requirements under securities legislation and SRO Rules regarding disclosure of fees and charges and are intended to avoid duplication of disclosure. As noted by a commenter, disclosure of fees and charges under the Point of Sale initiative would only be provided to the client at the time of purchase and does not contemplate the provision of information on a redemption. Proposed requirements with respect to relationship disclosure under Rule 2.2.5 are intended to provide clients with general information regarding how the Member is compensated and are not specific to a transaction. As noted, the number of investor complaints that staff has received on this issue point to a regulatory need for the provision of fees and charges information *at the time of the transaction* and the Proposed Amendments are intended to respond to this need.

Types of Fees and Charges Contemplated by Proposed Amendments

Commenters also sought clarification on the types of fees and charges contemplated under the Proposed Amendments. In particular, they inquired whether disclosure of withholding tax on RRIF and Registered Retirement Saving Plan (RRSP) accounts, chargeback of Registered Education Saving Plan ("RESP") grants, Labour Sponsored Investment Fund ("LSIF") tax credit claw-backs and fees for accounts held at intermediaries would be required.

MFDA Response

Rule 2.4.4 requires disclosure of direct fees and charges deducted from either the proceeds to be received or the amount to be invested by the client at the time of the transaction that would be reflected on the trade confirmation. This would include sales charges, redemption fees, switch fees, or applicable withholdings related to the order (including taxes and clawbacks deducted from proceeds to be paid to the client at the time of the transaction). Fees or charges that are not related to an order (for example, account administration fees including trustee fees or account transfer fees) or that are not deducted at the time of the transaction would not be subject to the proposed Rule as their disclosure is required under other MFDA requirements.

Availability of Information re: Transaction Fees and Charges

IFIC, IGM and PFSL sought clarification of the following issues with respect to the availability of information with respect to fees and charges.

- Fund managers have the information required to determine DSC charges accurately and levy short-term trading fees at their discretion. As a result, dealers would have to contact fund managers directly at the time of redemption to obtain accurate information in respect of such fees and charges, thereby delaying timely execution of the transaction; and
- Redemption charges are determined based on the net asset value of the fund, which is set at the *end* of the day on which the transaction is executed. As a result, such information *may not be determinable* at the time of redemption.

IFIC and PFSL noted that the Publication Notice clarifies that investors may be provided with a reasonable idea or an estimate of transaction fees and charges, where it is otherwise difficult to provide specific information and suggested that the Proposed Amendments be amended to reflect such flexibility.

Desjardins and IFIC expressed the view that even when an approximate charge is disclosed to an investor, it will only lead to varied investor expectations and may result in complaints once the exact charges are deducted from the investor account.

FAIR suggested that proposed Rule 2.4.4 be amended to specifically require that fees and charges be provided in dollars and cents unless impractical due to unavailable information. FAIR also recommended that the Rule be amended to require that where specific information in respect of transaction fees and charge is not available, as much accurate and detailed information as possible be provided such as by providing an estimate. FAIR also suggested that if MFDA Members or their representatives are unable to determine the fees and charges associated with a particular transaction, perhaps a more transparent means of calculating such fees and charges in the mutual funds industry is warranted, having regard to the impact of fees and charges on fund performance and the importance of such information to investor decision making.

MFDA Response

As noted, a forthcoming companion Member Regulation Notice will clarify that the Proposed Amendments are not intended to impair timely execution of client orders. In such circumstances, Members and Approved Persons are expected to provide as much accurate and detailed information as can reasonably be provided in the circumstances without delaying the transaction.

We also note that the complaints we have received relate to situations where a client was not informed that there would be any fees or charges in relation to the transaction, rather than cases where the specific amount was not provided. MFDA staff is aware that, in specific circumstances, the provision of detailed information with respect to fees and charges may not be possible. In such situations, Members will be expected to comply with the basic objectives of the Proposed Amendments, as noted above and, in doing so, act reasonably and in the best interests of the client. For example, where more current or accurate information is not available or obtainable in a timely manner, Members and Approved Persons could provide an estimate, expressed as a percentage or in dollars, of the fees and charges that would apply on a transaction.

MFDA staff recognizes that disclosure of the exact amount of short-term trading fees may be difficult as complex calculations may be required in addition to the fact that short-term trading fees are applied at the discretion of the fund company. Accordingly, Members and Approved Persons may comply with the requirements of Rule 2.4.4 by advising the client in circumstances where a short-term trading fee may apply.

Requests for Clarification

Commenters also sought clarification as to the application of the Proposed Amendments in the following circumstances:

- transactions executed directly with a fund company (where the dealer does not become aware of the transaction until after the redemption);
- where clients fax in letters of direction to their advisor to request a redemption but provide no contact information for the purpose of fees and charges disclosure;
- online transactions; and
- transactions in automatic withdrawal plans (where fees and charges vary by transaction).

IFIC also requested clarification regarding whether the transaction would have to be delayed in situations where the client is unreachable for fee disclosure.

MFDA Response

Where a client contacts the fund company directly to make a redemption request, and the Member and its Approved Persons do not become aware of the redemption until after the order has been accepted/redemption has occurred, they would not be expected to provide the disclosure.

With respect to online, unsolicited (i.e. client-initiated) transactions, given that an Approved Person is not involved in accepting the order, it may be impractical to provide detailed, specific information with respect to transaction fees and charges. Accordingly, with respect to such transactions, Members may comply with the requirements of Rule 2.4.4 by notifying clients of the types of fees and charges that may apply and advising them to contact the Member if they wish to obtain further details on applicable fees and charges prior to proceeding.

In respect of automatic plans, staff would expect Members and their Approved Persons to provide as much current and accurate information about fees and charges as is available at the time that the plan is being established, but would not expect such disclosure to be provided on each subsequent transaction.

With respect to delaying transactions where clients are unreachable for timely fees and charges disclosure, we note that in the majority of circumstances, there is direct interaction between the Member and its Approved Persons and the client. In the rare situation where a client places an unsolicited order and is unavailable or unreachable for disclosure regarding fees and charges

on a transaction, Members and Approved Persons would be expected to use reasonable efforts to contact the client and advise of the transaction fees and charges. This may involve sending a communication back to the client (via e-mail, fax or phone) to advise that fees or charges will apply to the transaction and notifying the client that if they do not respond within a specified time period, the transaction will be executed in accordance with the client's instruction. In setting a specified time period for client response, Members must comply with requirements under securities legislation with respect to the timely execution of trades.

Received "In Good Order" Requirements

PFSL noted that redemption requests are forwarded to fund companies for processing if they are received "in good order". If the proposed disclosure becomes part of such "in good order" requirements, orders received from clients by fax or mail would not be "in good order". This would require changes to processing procedures that would result in significant delays in processing client transactions.

MFDA Response

The disclosure obligations contemplated under the Proposed Amendments are not intended to form part of such requirements (i.e. they would not form part of the instructions to the fund company/the transaction order between the dealer and the fund company).

Requirement for Records (Rule 5.1)

IFIC expressed the view that the requirement under proposed Rule 5.1 to include evidence that a client was informed of all redemption fees and charges is not information that is considered part of the normal books and records of a dealer. IFIC noted that dealers have less control over compliance with disclosure by registrants in the field than over accounting items recorded in the books and records of the firm. IFIC submitted that non-compliance with the books and records requirement of the Rule is of a different order of magnitude than non-compliance with a disclosure requirement, and proposed that subsection 5.1(b)(iv) instead be included as an amendment to Policy No. 2 *Minimum Standards for Account Supervision*.

IGM indicated that Approved Persons are already under an obligation to document client instructions, which, in particular situations, may include recording discussions regarding fees and charges. IGM was of the view that where such a discussion has taken place but, for whatever reason, is not documented, the Rule, as proposed, will create a presumption that the issue was not covered with the client, whereas in the current situation, the Approved Person would simply be at an evidentiary disadvantage.

MFDA Response

Rule 5.1 requires Members to maintain such books, records and other documents that are necessary for the proper recording of its business transactions and financial affairs (i.e. any record created, used or maintained as part of Member business). As a result, this requirement is not limited to accounting records but would include client files, communications with clients and records of trade orders and client instructions (which would include the evidence of disclosure requirements contemplated under the Proposed Amendments).

The Proposed Amendments do not create any new presumptions against the Member or its Approved Persons. Rule 5.1(b) currently requires Members to keep an adequate record of each order and of any other instruction given or received for the purchase or sale of securities. In the absence of such a record (i.e. client notes), Approved Persons would presently leave themselves open to allegations of having engaged in unauthorized or inappropriate trading, without any documentary proof to substantiate a contrary position. The disadvantage created by this failure to comply with existing MFDA requirements is not impacted by the Proposed Amendments.

Costs

IFIC and Desjardins expressed the view that the Proposed Amendments will generate significant costs by requiring dealers to develop new forms and systems to store information and track and monitor compliance, as well as requiring additional compliance resources. Desjardins noted that, given the potential for generating trivial complaints if the Proposed Amendments become effective, dealers will be compelled to expend significant resources both in monitoring Approved Person compliance and developing information systems in order to generate the most precise estimates of fees.

MFDA Response

The Proposed Amendments codify and standardize existing industry practice and provide flexibility as to how clients can be made aware of the required information. As noted, the disclosure requirements of the Proposed Amendments may be satisfied either through the provision of a document or by having a discussion with the client. For the purpose of complying with the recording keeping requirements of proposed 5.1(b)(iv), Members may use the current methods that they employ to evidence

client orders and instructions for example, maintaining detailed notes to file, taping telephone conversations or maintaining copies of client acknowledgements prior to the acceptance of the client order. Members may augment their existing compliance control environments by making back office changes; however, staff notes that achieving such compliance controls through a manual process would also be acceptable.

Method of Providing Information re: Transaction Fees and Charges

Kenmar, noting that the proposed disclosure may be provided by way of verbal or written communication, recommended, where evidence of disclosure is obtained telephonically and taped, that the investor be advised that the conversation has been taped and will be retained on file. Both Kenmar and FAIR indicated that disclosure should be in plain language, in dollars and cents (to the extent practicable), avoid industry jargon, abbreviations, and acronyms, and be presented in a way that is meaningful to individual investors.

MFDA Response

Members that tape client telephone calls are currently required to provide clients with disclosure of this practice under existing privacy legislation. Members and Approved Persons are expected to provide the disclosure required under the Proposed Amendments in a manner that is clear, not misleading and consistent with its basic objectives, as noted above.