

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

July 6, 2010

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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)¹. The RRs recognized the MFDA under their public interest mandate.

The RRs rely on the MFDA to carry out certain regulatory functions. These responsibilities are detailed in the Recognition Orders (ROs) and the MFDA has agreed to be bound by the terms and conditions (T&Cs) within the ROs as it carries out those responsibilities. The RRs are responsible for conducting 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 a number of regulatory functions at the three MFDA offices.

2. Purpose and scope of the oversight review

The objectives of the oversight review are:

- to assess whether the MFDA is in compliance with the relevant T&Cs of its ROs as an SRO².
- to determine whether the MFDA's regulatory processes are efficient, effective, consistent, and fair.
- to evaluate whether the MFDA has adequate staffing, resources, and training to perform its regulatory functions effectively and efficiently.

RR staff coordinated the timing of the oversight review and evaluated the different offices using one review program. This coordinated review covered the period from July 1, 2005 to December 31, 2008 (the Review Period). Because the MSC and the NBSC did not recognize the MFDA until 2007, their part of the review covered a shorter review period, from date of recognition to December 31, 2008.

¹ 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.

² Although some parts of the report refer to the T&Cs of specific ROs, all of the MFDA's ROs have similar or identical requirements.

As the Principal Regulator³ of the MFDA, BCSC staff were the sole reviewer of certain head office functions in Toronto. For the other functions that are centralized at head office, but operate nationwide, RR staff's review generally focused on activities related to their respective jurisdiction or region. For the regional offices, BCSC staff reviewed the Pacific Regional Office (PaRO) while ASC, MSC and SFSC staff jointly reviewed the Prairie Regional Office (PrRO). The following summarizes the key areas that RR staff examined:

MFDA office	Areas examined	RR staff
Toronto Head Office	Fees setting	BCSC
	Policy development/administration	BCSC
	Enforcement – case assessment	ASC, BCSC, MSC, NBSC, NSSC, OSC, SFSC
	Enforcement – investigations	NBSC, NSSC, OSC
	Enforcement – litigation	OSC, BCSC, ASC
	Compliance – sales compliance	NBSC, NSSC, OSC
	Compliance – financial compliance	ASC, OSC
	Membership	OSC
	Business continuity plan	BCSC
	Cooperative Agreement in Québec	BCSC
Pacific Regional Office	Enforcement – investigations	BCSC
	Compliance – sales compliance	BCSC
	Membership	BCSC
Prairie Regional Office	Enforcement – investigations	ASC, MSC, SFSC
	Compliance – sales compliance	ASC, MSC, SFSC
	Membership	ASC

3. Consolidated report

This report consolidates the reports of the RRs. NBSC, NSSC and OSC staff prepared a report of their joint review of the Toronto Head Office, while the ASC, MSC and SFSC staff prepared a report of their joint review of the PrRO and some functions of the Toronto Head Office. BCSC staff combined the two reports with their report of the PaRO and some head office functions to produce the consolidated report.

BCSC staff organized the consolidated report by MFDA office. As the MFDA's Case Assessment, Litigation and Financial Compliance groups are only located in its Toronto Head Office, ASC, BCSC, MSC, and SFSC staff reviewed some of these functions as they relate to matters originating from their respective provinces. Their respective findings are found in the Toronto Head Office part of this consolidated report.

³ The Principal Regulator is the RR mainly responsible for coordinating the RRs' review of the SRO's submissions, e.g., by-law and rule proposals, and reporting under the RO and consent orders; coordinating the oversight reviews; and arranging and chairing CSA/SRO oversight committee meetings.

To reduce duplication, RR staff combined common information related to departmental structure, procedures and processes, and resources and training, and combined the report sections for Case Assessment, Litigation and Financial Compliance. However, for the remainder of the areas reviewed, RR staff did not combine common staff findings and recommendations found among the three reports, instead they are included in their entirety.

RR staff also ensured their findings did not contradict for the same item or process examined. Any differences appearing in the consolidated report are due to regional differences such as the way processes are administered and managed for a particular region.

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. Overall assessment

RR staff are satisfied that, during the Review Period, the MFDA operated in the public interest with a focus on protecting the investing public. For the most part, the MFDA was compliant with the relevant T&Cs of its ROs.

The MFDA’s Compliance and Policy departments continue to guide its maturing membership towards a culture of compliance and are reasonably responsive to emerging industry trends. From the enforcement files reviewed, the Enforcement Department has acted decisively against misconduct, as RR staff generally found the case outcomes and the sanctions reasonable. The Financial Compliance group is able to mitigate existing and potential risks to protect the investing public. Generally, the MFDA’s processes are efficient, effective, consistent, and fair; and it has adequate staffing, resources, and training processes to perform its regulatory functions effectively and efficiently.

Nevertheless, RR staff have high and medium priority recommendations for the Compliance Department at the PrRO and for the Financial Compliance group at head office. In addition, ASC, MSC and SFSC staff have recommendations specifically for the Prairie region. The recommendations identify areas for improvement that require the MFDA to take remedial action.

II. Toronto Head Office

A. Summary

1. Background

During January and February 2009, RR staff conducted a review of certain functions at the MFDA's Toronto Head Office. Please refer to I.2 for the areas examined by staff of each RR.

BCSC staff reviewed the MFDA's:

- policy development and administration
- business continuity plan (BCP)
- management of the Cooperative Agreement in Québec (the Agreement)
- case assessment and litigation processes for the Pacific region

OSC, NBSC and NSSC staff jointly examined the MFDA's:

- enforcement (case assessment, investigations, litigation)
- sales compliance
- financial compliance
- membership

ASC, MSC and SFSC staff jointly reviewed the MFDA's case assessment for the Prairie region. ASC staff reviewed the MFDA's financial compliance for Alberta.

2. Assessment of findings

(a) BCSC staff's assessment

BCSC staff interviewed MFDA staff, board and board committee members and chairs, and the Autorité des marchés financiers du Québec (the AMF) staff; reviewed internal policies and procedures, board and board committee minutes, and relevant documents, materials and agreements; visited the MFDA's emergency recovery facility; and examined a sample of working files for the Policy Department, and enforcement and compliance files.

Overall, BCSC staff were satisfied with the MFDA's policy development and administration, BCP and disaster recovery plan (DRP), and management of the Agreement in Québec.

From the review of the MFDA's policy function, BCSC staff found the MFDA's processes for identifying and addressing policy issues appear to be reasonable and adequate. Policy staff work closely and effectively with senior staff from the Compliance and Enforcement departments, as well as senior management, to identify regulatory risks and develop regulatory responses on a timely basis.

Regarding the MFDA's BCP, BCSC staff generally found it adequately accounts for the users' needs under crisis conditions and uses appropriate procedures that would enable the MFDA's prompt recovery during a major business interruption while maintaining appropriate service levels with its stakeholders.

BCSC staff were also satisfied with the MFDA's management of the Agreement in Québec. The MFDA's regulation of its Québec members for compliance with prudential, and business conduct and sales practice rules is consistent with its regulation of its non-Québec members. Its processes for referring complaints and sharing information with the AMF and the Chambre de la sécurité financière (the Chambre) about its Québec members and Approved Persons (APs) are adequate. BCSC staff found good coordination between the MFDA and the AMF regarding policy development to ensure continued harmonization of their rules and regulations.

Finally, BCSC staff were satisfied with the regulatory processes for Case Assessment and Litigation groups for the Pacific region. Collectively with the PaRO's Investigations group, BCSC staff found the MFDA's Enforcement Department met its regulatory responsibilities of protecting investors and deterring future transgressions in the Pacific region. Specifically, Case Assessment and Litigation groups met their benchmarks, were sufficiently resourced with qualified and trained staff, and produced good quality files with reasonable file outcomes. However, due to the relatively few litigation cases in the Pacific region, BCSC staff questions whether this is due to lack of local resources.

(b) OSC, NBSC and NSSC staff's assessment

Based on interviews with MFDA staff, reviews of the MFDA's policies and procedures and reviews of files, OSC, NBSC and NSSC staff are generally satisfied with the regulatory processes of the MFDA.

At the time of the field review, the departments were fully staffed. There was adequate training provided to MFDA staff, and there was an appropriate level of management oversight. There were adequate policies and procedures in each department, and these procedures were generally followed. Where feasible, processes were standardized to ensure that MFDA staff took a consistent approach in the work performed.

OSC, NBSC and NSSC staff reviewed the process for selecting members for compliance examinations and found that they are prioritized for review based on a number of factors, including their risk. NBSC and NSSC staff found that during the Review Period, the MFDA had increased its presence, in terms of number of compliance field reviews, in New Brunswick and Nova Scotia. However, NBSC and NSSC staff believe that the MFDA should continue to increase the frequency of examinations of members in these provinces. OSC staff also recommended that, in light of the risk Level 2 and 3 dealers may pose, the MFDA consider whether the

frequency of financial compliance examinations for these dealers should be increased.

OSC, NBSC and NSSC staff also reviewed the benchmarks used by the MFDA and assessed whether they were adequate, properly monitored, and met. Staff noted that, throughout the Review Period, the Enforcement and Compliance departments have generally met their performance benchmarks. However, OSC staff found that the performance benchmarks for Compliance and Financial Compliance should be clarified and consistently used, and their continued appropriateness should be reviewed and reassessed. OSC staff also recommended that the MFDA establish benchmarks for completing the review of members' auditor working papers.

OSC, NBSC and NSSC staff reviewed enforcement and compliance files and found the work to be thorough and properly documented. The examination procedures applied in compliance reviews were adequate and comprehensive, however OSC staff found a number of areas where they could be enhanced and made recommendations in this regard. OSC staff noted that some of the MFDA's capital requirements may not be fully understood by its members' auditors, and found that the MFDA has already started a process to educate them. OSC staff encourage the MFDA to continue its efforts in this area.

(c) ASC, MSC and SFSC staff's assessment

ASC, MSC and SFSC staff were generally satisfied with the case assessment process and procedures, the training and support for new and existing Case Assessment staff, and the quality of case assessment files for the Prairie region. However, MSC staff were concerned with lack of documentation of the warning call and the ineffective use of warning letters for the Prairie region.

ASC staff also examined a sample of financial compliance examination files for Alberta. ASC staff were satisfied that the financial compliance examination process is comprehensive and Financial Compliance appears to accomplish its objectives in Alberta.

B. Fees

1. Introduction

The BCSC RO requires that fees imposed by the MFDA on its members should not have the effect of creating barriers to membership and should be designed to ensure that the MFDA has sufficient revenues to discharge its responsibilities.

The RO also requires that the MFDA's process for setting its fees be fair, transparent and appropriate.

2. Purpose and scope

BCSC staff reviewed the MFDA membership fee setting process for reasonableness. We also assessed whether the existing fee structure helps the MFDA generate adequate revenues that enable it to discharge its responsibilities and to ensure compliance with T&C #4 of the BCSC RO.

3. Membership fees

(a) The fee structure and the fee setting process

Background information

The MFDA provided documents setting out the process for determining fees for each fiscal year. BCSC staff also received and scrutinized the membership rate schedule for fiscal 2010.

BCSC staff interviewed senior management involved with the fee setting and budgetary processes. We selected a sample of fees for two fiscal quarters, and reviewed the billings and reconciliations to the accounting records.

Staff findings

The fee setting methodology appears reasonable and the existing structure adequately provided revenues to meet the MFDA operating requirements over the Review Period.

Staff recommendations

None.

C. Policy

1. Introduction

T&C #10 of the BCSC RO requires the MFDA to establish such rules as are necessary or appropriate to govern and regulate all aspects of its business and affairs.

Prior to proposing any new rule, or changes to, or suspension of a rule, T&C #11 of the BCSC RO requires the MFDA's board to determine that enacting such rule, or change or suspension of the rule, would be in the public interest. A statement to that effect must accompany every proposed new rule, change or suspension.

The MFDA's Policy and Regulatory Affairs Department (Policy Department) is led by a director. The Policy Department is responsible for developing and interpreting, in collaboration with other MFDA departments, policy initiatives relating to MFDA members. The department is the main contact with the Canadian Securities Administrators (CSA) for policy matters and is a central resource for MFDA staff regarding policy and rule interpretation.

2. Purpose and scope

The purpose of this part of the review is to determine whether the MFDA has the appropriate processes and resources in place to identify regulatory issues or emerging trends on a timely basis; to ensure that the MFDA effectively and efficiently addresses regulatory issues, while fulfilling its public interest mandate; and to assess the MFDA's use of policy committees and ad-hoc committees, as well as whether those committees adequately consider matters that may result in new rules or rule amendments. BCSC staff also assessed whether the MFDA properly granted relief from its requirements.

3. Department structure

Background information

The Policy Department, led by the Director with three legal and policy counsel and one policy analyst reporting to her, has policies and procedures for identifying and tracking regulatory initiatives and policy issues, as well as developing and amending regulatory instruments.

Policy staff are responsible for working directly with MFDA members, policy committees, regional councils, other SROs and securities regulators to identify and address regulatory issues and concerns; developing and interpreting regulatory instruments, in collaboration with other MFDA departments, including evaluating operational issues that might inform any proposed changes, such as impact on members and investors; providing advice and legal, drafting and research support to other MFDA departments; and assisting members in the interpretation and application of MFDA rules. The director is also responsible for overseeing the department; managing, coordinating with other departments and ensuring a timely response to CSA oversight and reporting requirements, as well as working with the CSA to develop a harmonized approach to oversight and regulatory issues generally.

Policy staff consult and coordinate with staff from other departments on a regular basis, in particular the Compliance and Enforcement departments, and senior management, to discuss regulatory initiatives. At these meetings, staff develop responses; assign priorities; and establish timelines for addressing each issue, and monitor ongoing issues.

The Policy Department is most often responsible for drafting regulatory instruments for discussion at these inter-departmental meetings. Policy staff also draft memoranda recommending the regulatory response for presentation to policy committees, board committees, and the board.

The Policy Department participates in the MFDA's annual internal review of departmental policies and procedures to ensure that it is following its processes and that the department updates them as necessary.

BCSC staff met with the MFDA's Director of Policy and Regulatory Affairs, its Executive Vice-President, the Chair of the Regulatory Issues Committee of the board of directors (RIC), and the Chair of the board. BCSC staff also reviewed the MFDA's internal policies and procedures; the minutes and materials of the Policy Advisory Committee (PAC), the RIC, and the board; Member Regulation Forum materials; Annual General Meeting (AGM) materials; and a sample of working paper files.

BCSC staff also reviewed the internal policies and procedures of the Policy Department and the job descriptions for its staff.

Staff findings

The MFDA's processes for identifying and addressing policy issues appear to be reasonable and adequate. Policy staff work closely and effectively with senior staff from the Compliance and Enforcement departments, as well as senior management, to identify regulatory risks and develop regulatory responses on a timely basis.

The internal procedures for Policy staff provide guidance on identifying and addressing policy issues, as well as considering exemptive relief applications, submitting rules for review and approval by the CSA, and developing member regulation notices. They are reasonable and adequate.

Staff recommendations

None.

4. Staffing resources and training

Background information

BCSC staff interviewed the Director of Policy and Regulatory Affairs and the Executive Vice-President, and reviewed the training materials for Policy staff.

The Policy Department is fully staffed. During the Review Period, the department created a policy analyst position to add someone with industry experience to the group, in addition to the three legal staff and director.

Policy staff participate in MFDA wide training. Staff are also required to take part in a compliance examination of an MFDA member to gain an understanding of that process.

Staff findings

The Policy Department has appropriate resources and training for its staff.

Staff recommendations

None.

5. Problem identification and rule development

BCSC staff interviewed the Director of Policy and Regulatory Affairs and the Executive Vice-President, and reviewed the internal policies and procedures of the Policy Department and the job descriptions of its staff. BCSC staff also examined a sample of policy files related to rule proposals and member regulation notices; as well as PAC, RIC, and board materials and minutes.

(a) Problem identification

Background information

Policy staff identify regulatory initiatives by monitoring securities regulatory and industry developments nationally and internationally; by gathering information from the Compliance and Enforcement departments, exemption applications, the PAC, its members, and public inquiries; and from CSA requests.

In addition, in 2007, at the request of the board, the MFDA surveyed its members about its rulebook to assess the effectiveness of its rules and the regulatory burden on its members. This review resulted in a number of regulatory responses by the MFDA.

Once it identifies an issue, the Policy Department generally does not develop a response on its own, but in consultation with staff from other MFDA departments and senior management.

Staff findings

The MFDA has appropriate processes in place for identifying regulatory matters and emerging trends in a timely manner.

Staff recommendations

None.

(b) Evaluation and consideration of alternatives

Background information

The internal procedures for identifying and tracking regulatory issues and for developing regulatory instruments do not refer to evaluation or consideration of alternatives. However, the job descriptions for all Policy staff positions require staff to conduct research to determine alternative solutions to regulatory issues and their potential impact on members and the investing public. They must also consider comparable approaches used by other securities regulators.

MFDA management informed BCSC staff that Policy staff consider alternative solutions as an implicit and fundamental part of the policy development process at initial and subsequent staff meetings. When considering alternatives, Policy staff most often look to the approach of the Investment Industry Regulatory Organization of Canada, the most relevant comparison for the MFDA.

In addition, MFDA staff informed BCSC staff that its Policy staff discuss generally the potential impact of regulatory initiatives at staff meetings. During the policy development process, the MFDA also gets feedback, about potential impact of proposed policies on members, from the Member Regulation Forums and PAC.

Staff findings

Although BCSC staff is confident that Policy staff discuss both alternative solutions and the potential impact of a proposal on members and investors during staff meetings and respond to questions from the board about such issues if asked, we were not always able to find evidence of these discussions or what issues staff considered. The lack of evidence made it difficult to evaluate the extent of such discussions.

Staff recommendations

The MFDA should document staff, committee and board consideration of alternative regulatory responses, as well as potential impact on members and the investing public, to ensure there is a more complete record of the deliberations and decisions made in the development of regulatory proposals.

Priority: Low.

MFDA's response:

We have amended our procedures to require the documentation of staff, committee and Board consideration of alternative regulatory responses and the potential impact on Members and the investing public.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response. We ask that the MFDA provide BCSC staff with a copy of the revised procedures by September 30, 2010.

(c) Rule development

Background information

Once Policy staff have identified a regulatory initiative, they record it on the Regulatory Instrument List and assign it a priority level of low, medium or high. Regulatory instruments include rules, by-laws, policies, and member regulation notices. When Policy staff have finalized a draft instrument, which senior staff and management agree to, Policy staff draft a memo summarizing the proposal and take the proposal to the PAC for comment.

MFDA staff also raise significant policy initiatives at the MFDA's biannual Member Regulation Forums to keep members informed about policies the MFDA is currently developing, what proposals it has published for comment, and to solicit any initial comments from its members. Staff record member questions and the MFDA's responses, which may lead to changes to the proposals, if appropriate.

After consideration by the PAC, MFDA staff present proposals to the RIC, which is responsible for engaging in preliminary board consideration of rule, by-law and policy proposals. If the RIC is supportive of a proposal, the RIC and Policy staff recommend the proposal to the full board. Once the board has approved the proposal, the MFDA submits it to the RRs of the CSA for review and approval. To make them effective, members at the AGM following the approval of the rule by the board must approve rule amendments. To become effective, by-law amendments must be approved by at least 2/3 of the votes cast at a meeting of members to consider the amendments. The MFDA generally brings proposed amendments to both its rules and by-laws to the AGM of its members.

Staff findings

The MFDA's rule development process is reasonable and adequate. Senior staff are actively involved in drafting and considering changes to proposals throughout the process.

The RIC and board appear to have discussions of reasonable length and depth about the information they receive from staff and appear confident asking staff to reconsider issues or to consider them further. There appears to be good communication between staff and the board. There is evidence of open discussion at the RIC and board level and an ability to express dissent.

The MFDA's procedures for developing regulatory instruments state that staff will advise the board of the views of the RIC and of the consultations with MFDA members and the CSA. Staff memoranda to the RIC and board, which were reviewed by BCSC staff, stated that the PAC and/or members had been consulted. However, the memoranda did not contain any details about whether there were any material comments and if so, what changes, if any, staff made to the proposal and why. The memos did not contain details of what changes, if any, staff made to the

proposal because of PAC comments or whether staff decided not to adopt member suggestions. Staff advise that they usually speak to these issues at the meeting and minutes from these meetings sometimes record questions from the board about whether the PAC had any material comments.

Staff recommendations

The MFDA should document all issues raised by the PAC and members through other forums to ensure there is a more complete record of member comments, as well as staff and board's consideration of those comments.

Priority: Low.

MFDA's response during the review

Following the Review Period, the Policy Department undertook to include discussion about the PAC's and other member comments, as well as MFDA staff's responses to those comments, in staff memos to the RIC and board.

MFDA's response:

All material PAC comments and any other Member comments received, MFDA responses to these comments and any changes made to proposals as a result of the comments are now included in memorandums to the RIC and Board.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response.

6. Policy committees

BCSC staff met with the Director of Regulatory Affairs, the Executive VP and the Chair of the RIC; and reviewed MFDA policies and procedures for consultation with policy committees; the PAC terms of reference; notices of calls for applications to the PAC; minutes and materials for PAC meetings; and notices, materials and records of Member Regulation Forum meetings.

Background information

The MFDA consults regularly with its members about regulatory initiatives it is considering or proposing, including through ad-hoc committees and its standing PAC.

The PAC is made up of senior staff and officers of MFDA member dealers. It consisted of between 12 and 15 members during the Review Period, including the chairs of each Regional Council. The MFDA seeks applications for committee membership periodically, by issuing a bulletin to its member dealers, from which senior staff recommends members to the President and CEO. The MFDA selects PAC members with a view to ensuring that the committee is reasonably representative of the diversity of MFDA membership, including regional representation, size and type of business, and ownership structure. The MFDA expects members of the committee to have an excellent knowledge of securities law and mutual fund regulation, as well as strong technical abilities and an interest in the development of securities regulatory policy.

The MFDA does not receive many applications from small member dealers to sit on the PAC. To ensure diversified representation, MFDA staff have invited the current small dealer representative on the PAC to participate on the committee. Also, MFDA staff advise that they get calls from small dealers periodically and consider their comments in policy development. In addition, two small dealers were asked to make presentations to the board during the Review Period about the particular issues facing that constituency.

The MFDA calls for applications for the PAC every two or three years. There is natural turnover on the committee in the interim period due to changes in the chairs of the Regional Councils. The MFDA recently expanded the number of members on this committee because of the significant number of qualified applicants who applied. This has led to greater discussion during committee meetings.

Policy staff consult with the PAC on all policy initiatives that will have a material impact on members' operations. In addition to rule and by-law proposals, staff began bringing significant member regulation notices to the PAC in response to member feedback received after the MFDA issued MR-0048 *Know-Your-Product* on October 31, 2005. Policy staff provide the PAC with a memo outlining the proposal and the proposed regulatory instrument in advance of PAC meetings, and present an overview of the proposal at the beginning of each meeting. Policy staff record the PAC's comments and discuss them with senior staff from Compliance and Enforcement to determine if they should result in changes to the proposal.

The MFDA also occasionally strikes ad-hoc committees or working groups, such as the Client Relationship Model working group, from which MFDA staff got significant feedback early and throughout the policy development process.

Staff findings

BCSC staff are satisfied that the PAC was reasonably representative of the constituencies of MFDA members during the Review Period. The MFDA reasonably considered how representative the committee was and whether it adequately represented all members.

The MFDA consulted regularly and appropriately with its policy committees and members. The PAC and ad-hoc committees appeared to consider adequately and objectively the regulatory instruments staff presented to them. MFDA staff also appeared to take committee and member comments into account and revised proposals, when appropriate, based on those comments.

The MFDA also publishes its proposals for comment after its board has approved them and it has submitted them to the CSA for approval. This provides an opportunity for members not on the PAC, as well as other stakeholders, to provide input. In the notices published during the Review Period, the MFDA did not include any information about the consultation process, including whom the MFDA consulted, whether there were any comments or the MFDA's responses.

As a result, although the MFDA did consult regularly during the Review Period and appears to have considered members' comments, the MFDA did not always communicate its policy development and consultation process to its members. There is a risk that without effective communication about its processes, MFDA members or other stakeholders may not understand its policy development process or the extent to which the MFDA consults and considers the comments it receives during that process.

After the Review Period, the MFDA has made communication and transparency a priority and proposed various measures to achieve these goals, including bringing housekeeping proposals to the PAC, putting staff discussion papers and PAC minutes on its members-only website, setting up regular meetings with industry groups, and soliciting comments during staff's development of policy proposals. To this extent, the MFDA published on July 28, 2009, Bulletin 0389-P *MFDA Policy Development Process*, where it clarifies and proposes enhancements to its process for rule development.

These measures should improve both internal and external communication about the development of policy proposals and transparency about that process. The CSA will monitor these efforts.

Staff recommendations

The MFDA should continue its efforts to provide more details to its members and the public about its consultation process during policy development, the results of its consultations and its responses to significant comments, to make the MFDA's reasoning more transparent and ensure that members and the public understand the MFDA's policy development process.

Priority: Medium.

MFDA's response:

As noted in the Report and as described in MFDA Bulletin #0389-P "MFDA Policy Development Process", the MFDA made several enhancements to its policy development process to improve communication and consultation with stakeholders. This has included providing more detailed information on the Members' Only section of the MFDA website, ensuring longer comment periods for material regulatory proposals and soliciting preliminary comments from stakeholders in the concept or early development stages of a policy initiative. The MFDA will continue its efforts to ensure that Members are aware of upcoming and current policy initiatives and understand the issues, background and alternatives considered in determining a regulatory response.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response. BCSC staff will monitor the MFDA's efforts to improve communications and consultation with its members and the public.

7. Review of files

Background information

BCSC staff reviewed a sample of files, including three proposed amendments to rules and by-laws, two member regulation notices, and three exemptive relief applications.

Staff findings

The MFDA's process for reviewing exemptive relief applications is reasonable. MFDA staff appropriately considered the specifics of the application and the objective of the MFDA requirement, to determine whether the situation was unique and whether relief to one applicant would disadvantage other members. BCSC staff found the Policy staff's recommendations to be reasonable and the MFDA provided those applicants who were denied an exemption with an opportunity to appeal the decision. Policy staff's recommendations to the RIC were appropriately detailed, explaining the reasoning behind the recommendation. The working files evidencing staff's considerations included supporting correspondence, memos, and documents.

The MFDA's record keeping system for its regulatory instrument development process is reasonable and files contain drafts and memos about the regulatory proposals.

MFDA staff's recommendations about regulatory instruments appeared reasonable. There was evidence of consultation with management, the PAC, RIC and the board. There was no evidence of board discussion and approval in the files, but these were generally recorded in the board minutes relating to each proposal.

However, in the sample files reviewed, there was little documentation of the history of the regulatory initiatives, consideration of alternative approaches or potential impact on members or the public, or other regulators' approaches. There was no reference in the files or in the CSA correspondence binders to internal MFDA discussion about correspondence with the CSA. As stated above, to the extent MFDA staff consider these issues as an implicit part of the policy development process, these should be documented in the files or referred to in staff memos to ensure there is a record of staff and board rationale for deliberations and decisions during policy development.

Staff recommendations

Please refer to the staff recommendations in II.C.5(b).

Priority: Low.

MFDA's response:

We have amended our procedures to require the documentation of staff, committee and Board consideration of alternative regulatory responses and the potential impact on Members and the investing public.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response. We ask that the MFDA provide BCSC staff with a copy of the revised procedures by September 30, 2010.

D. Enforcement

1. Introduction

The MFDA is required by T&C #7 of the OSC RO to enforce compliance by its members and their APs with the MFDA Rules. T&C #8 deals with the MFDA's disciplinary process. It also requires the MFDA to provide advance notification to the OSC, the public and the media of hearings, and to notify them of the disposition of disciplinary actions or settlements.

In order to carry out its responsibilities, the Enforcement Department (Enforcement) is organized into the three functional groups described below and the Enforcement Policy Counsel.

The Case Assessment group (Case Assessment) is responsible for handling public inquiries and complaints, for reviewing filings in the Member Event Tracking System (METS)⁴ and assessing referrals from various sources. Where necessary, Case Assessment escalates cases to the Investigations group (Investigations).

Investigations conducts in-depth investigations of cases for violations of regulatory requirements. The group also coordinates investigation activity with other regulatory and law enforcement agencies. Where appropriate, the group refers cases to the Litigation group (Litigation) for consideration of commencement of formal disciplinary proceedings.

Litigation conducts disciplinary proceedings against members and their APs. Enforcement Counsel from this group provides advice to investigators on all cases and act as MFDA counsel in disciplinary hearings held before the Regional Councils.

2. Purpose and scope

The objective for this part of the oversight review was to evaluate whether Enforcement functions in an effective and efficient manner and meets the applicable T&Cs of the OSC RO by:

- assessing the adequacy of its reporting structure, staff resources and training
- reviewing the appropriateness of the benchmarks and sub-benchmarks in place and whether they are met
- understanding the processes and communications with other MFDA departments, such as Compliance and Policy, and with other regulators

⁴ MFDA Policy 6 *Information Reporting Requirements* (Policy 6) requires members to report certain events to the MFDA through an electronic system provided by the MFDA. METS is the electronic system established by the MFDA and was implemented in July 2007. Policy 6 lists the types of events to be reported, as well as the reporting timeframes. For example, members are required to report complaints they receive, legal proceedings, terminations, civil claims, and other significant events related to members and their APs.

In order to accomplish the objectives, OSC staff:

- reviewed the relevant provisions of the MFDA's By-Law No. 1 and applicable Rules
- interviewed management of Enforcement
- reviewed internal policies and procedures documents
- reviewed a sample of files completed during the Review Period by each Enforcement group in order to determine the adequacy, timeliness and quality of analysis performed by MFDA staff

This part of the report also includes ASC, BCSC, MSC, and SFSC staff's evaluation of the MFDA's handling of Pacific and Prairie regional case assessment matters; and BCSC staff's examination of the litigation process and litigation files at the Pacific region.

3. Department structure – reporting structure and management oversight

Background information

Case Assessment, Investigations and Litigation are each managed by a director. The department's Enforcement Policy Counsel provides advice to Enforcement staff on matters relating to cases. The Enforcement Policy Counsel also drafts and provides advice on agreements and undertakings, and develops and maintains various internal procedures and other records. The three directors and the Enforcement Policy Counsel report to the VP of Enforcement.

All Case Assessment and Litigation staff are located at the head office in Toronto, however certain case assessment officers (CAOs) consistently deal with a single region to understand the nature of complaints and gain expertise in their area of responsibility.

Enforcement management is very involved, from a supervisory perspective, in each case handled by the department. This includes meeting with staff to discuss cases, monitoring benchmarks and sub-benchmarks and, monitoring case aging, among other things. In addition, the Enforcement and Compliance management meets every two weeks to discuss the status of files referred to Enforcement. At these meeting, they also discuss potential referrals from Compliance to Enforcement such as significant repeat deficiencies and serious compliance weaknesses.

Staff findings

The MFDA Enforcement's reporting structure is adequate. There is adequate oversight, promoting consistency in the way similar fact cases are approached, and decisions are made, while allowing staff to develop professionally. OSC staff believe that management's hands-on involvement in cases, as well as its ongoing communication with the Compliance Department, alert it to emerging risks and industry trends early in the process. As a result, management responds in a timely manner by focusing enforcement resources towards high-risk areas. This is especially important in the current economic and market environment.

Staff recommendations

None.

4. Staffing resources and training

Background information

The number of enforcement staff positions has steadily increased from 36 on July 1, 2005 to 49 on July 1, 2008. This is an increase of 36% over a three-year period. At the time of our review, there were five vacancies in Enforcement, and a process was underway to fill them.

For the Pacific and Prairie regions, two head office CAOs are dedicated to deal with regional case assessment matters, one CAO for the Pacific region and one for the Prairie region. For the Pacific regional litigation cases, the MFDA uses head office litigation counsel, supplemented by local counsel as necessary.

Management reviews the staff levels both formally, as part of the annual budgeting process, and informally throughout the year, as part of the monthly review of benchmarks, case-aging and staff case loads. The VP of Enforcement also has regular one-on-one meetings with the directors of Case Assessment, Investigations and Litigation to discuss administrative matters. Management believes that the staffing levels are sufficient to handle the current caseload, but is alert to a potential increase in caseload, such as the recent increase in the number of complaints because of current market conditions. Management is monitoring the impact of this increase on Enforcement's ability to meet internal benchmarks and the consequent impact on staffing levels.

Enforcement has an orientation guide for training new staff. This guide includes a departmental procedures manual and other training materials. Enforcement also has annual training sessions (jointly with Compliance) that are divided into larger organization-wide sessions and smaller Enforcement-specific groups for more specialized training. In addition, Enforcement has periodic lunch-and-learn sessions organization-wide to discuss different topics of relevance, and monthly departmental meetings to discuss policy updates and procedures, and periodic topic-specific training. There is also mentoring and on-the-job training.

The same training is available to the regional offices. ASC, BCSC, MSC, OSC, and SFSC staff also reviewed the training materials.

Staff findings

OSC staff are satisfied that, at the time of the field review, the staffing levels were adequate and that there were adequate mechanisms in place to monitor staffing levels. In addition, OSC staff's review of the case-aging reports did not reveal any significant file backlog, which suggests that the staffing resources are sufficient. OSC staff noted that the MFDA had established processes to deal with the additional influx of cases and had recently positioned newly hired CAOs to do the initial screening of complaints. OSC staff encourage the MFDA to continue to monitor case volume and assess the impact on staffing.

Overall, BCSC staff are also satisfied that Case Assessment has sufficient resources to handle its current caseload for the Pacific region. However, BCSC staff note that there

are no staff litigation lawyers located in the Vancouver office or the Western region. Litigation matters are managed by either Toronto-based staff or outside counsel retained in the jurisdiction. BCSC staff were unable to determine whether the lack of local resources led to relatively few litigation cases.

OSC staff are also satisfied with the initial and ongoing training provided to Enforcement staff. Similarly, BCSC staff are satisfied that CAOs and litigators that deal with matters from the Pacific region have the necessary qualifications and training to perform their duties. BCSC staff also found Enforcement's training and orientation programs comprehensive and have kept up with industry and regulatory developments.

ASC, BCSC, MSC, and SFSC staff's findings related to other Enforcement staff training for the Prairie and Pacific regions are presented in IV.B.4(b) and III.B.4, respectively.

Staff recommendations

BCSC staff recommend that the MFDA evaluate the need for additional litigation resources in the Pacific region.

Priority: Low.

MFDA's response:

The issue of whether enforcement counsel are physically located in any particular province or region does not affect the number of litigation cases pursued in that area.

We will continue to monitor caseloads and other relevant factors relating to the issue of locating counsel in the Regional offices, and will take action as appropriate.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response.

5. Benchmarks and sub-benchmarks

Background information

The benchmarks used in Enforcement at the time of the review were as follows:

- Case Assessment - 80% of all cases must be closed or escalated to Investigations within 120 days of case opening.
- Investigations - 80% of all cases must be closed or escalated to Litigation within one year.
- Litigation - 80% of all cases must be closed, settled, or a Notice of Hearing issued, within 10 months from the time they are escalated by Investigations.

In addition to these benchmarks, in 2006 the MFDA implemented a number of sub-benchmarks to establish more detailed timelines for the completion of various steps involved in enforcement activities. The sub-benchmarks help managers monitor the progression of cases to ensure they ultimately meet their benchmarks. The MFDA reviews the adequacy of Enforcement benchmarks and sub-benchmarks annually. As part

of this review, the MFDA conducts annual self-assessments, which include monitoring adherence to the benchmarks.

During the Review Period, there was one formal change in the benchmark for completion of litigation files; the timeline was reduced from 365 days to 300 days, effective July 1, 2006. After the Review Period, on a test basis, the benchmark for investigations referred from the Compliance Department, was reduced to 220 days. In December 2009, management will assess the appropriateness of this test benchmark.

Staff findings

Overall, Enforcement is meeting its benchmarks and sub-benchmarks. Any exceptions are justified by the facts and the complexity of the particular cases. OSC staff are also satisfied with the processes used to monitor whether these benchmarks are being met as well as the process to ensure that they remain adequate.

BCSC and OSC staff found that the Case Assessment benchmarks are reasonable and appropriate, based on the complexity of the cases, the level of investigation expected, and staff's caseload. Case Assessment consistently met its benchmarks from 2006 to 2008. Litigation met its benchmarks for the Pacific region during the Review Period.

Staff recommendations

None.

6. Case Assessment group

(a) Case assessment processes and documented procedures

Background information

The MFDA's Case Assessment group is centrally located at head office. The group screens all complaints and inquiries, and completes the initial assessment of all cases, including those originating in the Pacific and Prairie regions. Case Assessment's primary function is to investigate complaints and referrals, and review METS filings.

The group receives complaints in a variety of ways including by written correspondence, e-mail or telephone calls. Also, other SROs, regulatory agencies, or MFDA departments such as Compliance, may refer complaints to this group. Once received, they are screened by case assessment analysts (CAAs) who fill out an *Intake Screening Checklist* to determine whether a case assessment file should be opened. If a file is opened, the manager assigns it to a CAO for review to recommend a course of action. If the matter is sufficiently complex and warrants additional investigation, or sufficiently serious and likely to lead to formal enforcement action, the CAO recommends that the file be escalated to Investigations. Otherwise, the CAO recommends that the file be closed with no action when no violation is established, or with an administrative resolution by issuing a warning letter or an Agreement and Undertaking (A&U). Files may also be referred to the securities commissions, if matters are outside the jurisdiction of the MFDA. In each case, management reviews and signs the recommendation report of

the CAO. The Escalation Review Committee (ERC)⁵ reviews all reports recommending escalation to Investigations, and if appropriate, will approve the recommendation. The process is tracked in the MFDA's Business Process Management (BPM) system.

CAAs also review METS filings on a daily basis and run weekly queries to detect more serious violations of MFDA Rules. METS is also used to track the members' timelines for resolving complaints and conducting internal investigations. Members that have not closed complaints within four months of receipt are sent reminders by the MFDA. If a member has not completed an investigation within six months, the MFDA will open a file to review the member's conduct. Files are also opened if the METS review shows that three or more complaints were received against a particular AP.

ASC, BCSC, MSC, OSC, and SFSC staff reviewed the written policies and procedures, the *Case Screening Scorecard*, and various case-handling guidelines and procedural templates used by Enforcement in general and Case Assessment in particular. These templates include a *Case Assessment Checklist* that is included in each file and sets out the steps to be completed in the course of the review.

The MFDA reviews and updates enforcement procedures and guidelines on an ongoing basis, especially at the bi-weekly meetings of the various enforcement groups. Both management and staff can suggest enhancements to existing procedures and guidelines, and participate in the drafting process.

Staff findings

ASC, BCSC, MSC, OSC, and SFSC staff found the written policies and procedures clear and comprehensive. The *Case Assessment Checklist* includes step-by-step descriptions of most processes to be followed when reviewing a complaint, from the receipt of a complaint to the closing of the case assessment file.

During the Review Period, the MFDA introduced new guidance materials for frequently encountered types of complaints and relevant regulatory requirements. The MFDA also established a timeframe for the sending of an opening letter to complainants acknowledging the receipt of an intake matter. ASC, BCSC, MSC, OSC, and SFSC staff believe that the guidance included in the written case assessment procedures is adequate and promotes consistency of processes.

The BPM system helps ensure that the work is tracked and that MFDA staff adhere to the case assessment file review process. Management also uses the BPM system to review aging reports and monitor whether benchmarks are met, thereby enabling timely management intervention.

⁵ The ERC meets weekly to decide whether to escalate cases that have been recommended by MFDA staff for escalation from Case Assessment to Investigations, or Investigations to Litigation. The committee consists of MFDA Enforcement management and the directors of both the Prairie and Pacific regions.

METS has been in place for over one year, and appears to be used effectively by the group. The METS information is used to assess members' risk profile and to determine whether cases should be opened. It is also used to identify trends and associated regulatory concerns.

Staff recommendations

None.

(b) Review of case assessment files

Background information

OSC staff reviewed a sample of 29 case assessment files closed during the Review Period. NSSC staff reviewed four case assessment files opened and closed during the Review Period and NBSC staff reviewed nine files closed during the Review Period.

From the Pacific region, BCSC staff examined a sample of 28 completed case assessment files. BCSC staff assessed the files for quality of the work (including reasonableness of the case outcomes), timeliness of the analysis and adequacy of the file documentation.

From the Prairie region, ASC staff reviewed 31 case assessment files, MSC staff reviewed 18 case assessment files and SFSC staff reviewed 14 case assessment files. Case assessment files contain a screening scorecard, correspondence related to the case, document requests and supporting documents, a phone log, analysis of the case, and a detailed case assessment report.

Staff findings

OSC, NBSC and NSSC staff's review of the sample of case assessment files shows that they were well documented and well organized, and that appropriate issues were considered by the CAOs assigned to the file. Generally, the files were completed on a timely basis and in accordance with the benchmarks established for Case Assessment.

Overall, OSC, NBSC and NSSC staff found that the actions taken (i.e., no action, warning letter, escalation to Litigation or a referral to another regulatory agency) were adequately supported by the evidence and analysis in the file. The reports outlining the CAOs' recommendations followed the standard format developed by the MFDA. All files, recommended for closure by the CAOs, with or without action, were reviewed by a manager of Case Assessment and the Vice President of Enforcement. The ERC, consisting of the Vice President of Enforcement, the Director of Litigation, the directors of the Prairie and the Pacific regions and the directors of Case Assessment and Investigations, reviewed files that were to be escalated to Investigations.

For the Pacific region, BCSC staff were generally satisfied that the CAOs were diligent and the quality of their work was consistently good. Their case analysis was objective and sound, and the case disposition or outcome was reasonable and supported by appropriate evidence on file. The CAOs followed the procedures and guidelines in processing their cases. BCSC staff also found that Case Assessment staff met the 120-day case completion benchmark for the majority of the cases in the file sample. Only three cases had gone significantly over the 120-day benchmark, however, in each case, the quality of the work was good and the reason for the delay was justified. Finally, BCSC staff found the files were well documented and well organized.

For the Prairie region, ASC, MSC and SFSC staff found that, in most cases, Case Assessment performs an adequate analysis of its cases. ASC, MSC and SFSC staff found that CAOs attempt to identify systemic patterns of non-compliance of the member or AP in certain circumstances. For instance, when Case Assessment receives a complaint that alleges misconduct by an AP, Case Assessment not only reviews the account(s) specifically belonging to the client in question, but in some files also required the member to select a sample of 25 other client accounts belonging to that AP to identify if any patterns of misconduct exist. ASC, MSC and SFSC staff found this particular MFDA process was well received by its members.

Staff recommendations

None.

(c) Additional areas examined

As a result of the MSC staff's review of a sample of Prairie regional case assessment and investigation files, potential concerns were identified that warranted a more in-depth examination. This is detailed below.

(i) Documentation of warning call

Background

One potential outcome of the case assessment or investigation process is for the MFDA to discipline the member or AP by issuing a warning letter. MFDA staff follow an internal process whereby they make a telephone call, before issuing the warning letter, to (i) the member if it was under review, or (ii) both the AP and Compliance staff of the member if the AP was under review.

Calls follow an established script as documented in the *Enforcement Department Procedure Manual*. In addition, the case reports record the date of the warning letter and the persons who were present at the warning call.

MFDA staff use the telephone call as an opportunity to communicate their findings, notify the party or parties under review that they will be receiving a warning letter, and stress the significance and meaning of the warning letter as a disciplinary measure.

Staff findings

During the file review, MSC staff identified that a copy of the warning letter is in each file but there is no documentation related to what was discussed on the warning call. A call log or memo to file that documents the details of each call could be pertinent if the MFDA encounters future enforcement cases with the same member or AP. The MFDA could also use the call logs to track how each member approaches the discipline it or its APs have received.

Staff recommendations

The MFDA should sufficiently document the details of warning calls as they are integral to the completion of case assessment and investigation files.

Priority: Medium.

MFDA's response:

The majority of warning calls follow the established script and involve no other material dialogue. We do, however, acknowledge that in some cases relevant information can be exchanged in these calls, and while notes are often maintained in those situations, it would be of assistance to maintain a standard procedure for ensuring notes of these calls are maintained in the files. We are revising our procedures accordingly.

Staff comments and follow-up:

MSC staff are satisfied with the MFDA's response.

(ii) Warning letters

Background

One potential outcome of both the case assessment and investigation process is for a member firm or AP to be disciplined by a warning letter. Generally, the warning letter briefly describes the violation of MFDA Rules and the complaint made by the investors. The letter also includes a description of the assessment undertaken by the MFDA and concludes with a general statement that the member or AP may have been in breach of the stated rules.

Staff findings

MSC staff reviewed the types of allegations in the files that were closed with a warning letter. It was determined by MSC staff that the MFDA utilizes the warning letter approach when closing files for various types of rule violations and various degrees of infraction. For example, a warning letter may be used for unsuitable leveraging or unsuitable investments, forging of client documents, or infractions of subordinated loan agreements.

This approach raises various concerns with MSC staff. The warning letter does not indicate the severity or level of rule violation, and does not state explicitly whether or not there was a rule violation. There is the potential for a member or AP to receive separate warning letters for infractions at either end of the spectrum but be unable to distinguish between the significance of the two

disciplinary measures. Furthermore, repeated receipt of a standardized warning letter may potentially lessen the impact or undermine the seriousness of certain breaches of MFDA rules and diminish the effectiveness of this type of discipline. In cases where investigation files are amalgamated, a firm or AP may only receive one letter to address all amalgamated files and resulting breaches of MFDA Rules. This practice also reduces the effectiveness of the warning letter.

MSC staff acknowledges that the warning letter is generally accompanied by a phone call to the member and/or AP by MFDA staff wherein more details of the findings may be discussed. However, at this time, the MFDA does not formally document these calls.

MSC staff recognized that MFDA staff have considered the use of the warning letter and may be taking steps to address the issue.

Staff recommendations

The MFDA should evaluate their use of warning letters to determine the overall effectiveness of the process.

Priority: Medium.

MFDA's response:

We have implemented procedures for the use of cautionary letters for minor violations, and for the use of warning letters for serious violations that do not warrant formal discipline. This will ensure that the level and seriousness of the violations involved are clear.

The MFDA issues warning letters (and now cautionary letters as well) in all cases where we identify one or more violations of applicable MFDA requirements. The letter summarizes the circumstances of the case and identifies the requirement that staff believes has been breached. It is important to remember that MFDA staff is not given the authority to make findings and warning letters cannot establish violations. The purpose of such a letter is to act as a deterrent to future potential non-compliance.

Where staff is of the view that there were multiple violations, we identify each violation separately in the letter, whether or not the case is amalgamated. The value in such a letter is the identification of each violation, and not in the actual number of warning letters sent on a specific date.

As with all the documents we use on a regular basis, the warning letter is based on a standard template which ensures that all applicable points are consistently addressed and Members consistently receive communications that cover all required issues. In our experience, Members and Approved Persons take these letters seriously. The incidence of repeat violations in warning letter situations is small and, where it has occurred, there

has been nothing to suggest that the repeat violation is related to the use of a standard template.

We believe that through the above processes we will continue to effectively administer informal discipline.

Staff comments and follow-up:

MSC staff are satisfied with the MFDA's response.

7. Investigations group

(a) Investigations processes and written procedures

Background information

OSC staff reviewed Enforcement policies and procedures, as well as written procedural templates and guides for handling various types of cases or alleged breaches. OSC staff also met with Enforcement management to discuss the investigation processes.

Files are typically referred to Investigations by Case Assessment, but may also be received from other sources, such as securities commissions or the MFDA's Compliance. When opened, each investigations file is assigned to an investigator and a litigator, regardless of the expected outcome. This process ensures Litigation staff are involved for the course of the file.

Throughout the conduct of a file, Investigations staff meet with their managers on an ongoing basis to discuss the progress of the investigation and any issues identified. Once an investigation is complete, the Investigator prepares a report setting out a recommended course of action. The recommendations report is reviewed by a manager and subsequently the ERC, which decides on the course of action.

This process may result in the MFDA issuing a warning letter to the member or AP; obtaining an A&U from the member; escalating the matter to Litigation; referring the matter to another regulatory body; or closing the file with no further action.

Staff findings

The Enforcement Department procedures and investigations manuals are comprehensive and address frequently encountered issues. The templates used by the group assist investigators in identifying the steps required for each type of alleged violation. This process helps ensure a consistent approach to investigation cases and promotes the completion of investigation cases in an efficient and effective manner. There are also adequate processes in place to ensure that Enforcement periodically updates its policies and procedures.

The investigations processes also appear adequate. The involvement of litigators in all files, as well as the investigators' ongoing interaction with management, allow

the investigators to develop and exercise professional judgement in the conduct of investigations. In addition, the processes allow for the early identification of opportunities to fast-track the investigation or to consider alternative or additional investigative steps.

Staff recommendations

None.

(b) Review of investigation files

Background information

OSC staff reviewed 10 investigation files, closed during the Review Period, in order to assess whether they were completed on a timely basis and were adequately and properly documented. NSSC staff reviewed three investigation files completed during the Review Period and NBSC staff reviewed eight investigation files completed during the Review Period.

Staff findings

Generally, the files reviewed had been completed on a timely basis and within the benchmarks. OSC staff found one file which failed to meet the benchmark for completion. This was largely due to the substantial number of investigation procedures required to be performed in that case. The MFDA has since made efforts to ensure a more efficient and effective use of resources by revising its processes and adopting new computer systems. For example, the MFDA reduced the use of a resource intensive process that required Enforcement staff to review a sample of 25 client account files of APs that raise suitability concerns and instituted a process that focuses on a firm-wide review of the member's policies and procedures. Also, the MFDA now uses Portfolio Aid, a software tool that facilitates better suitability analysis.

The investigation files were well documented. Each file contained, among other things; an investigations checklist identifying steps in the investigation; an approved investigation plan including an overview of the case, issues to be investigated, required documentation, tasks to be performed; and an investigation report setting out the findings and the recommendations. In addition, a documents log is used to record all case-related documents received.

OSC staff were also satisfied that the analysis of the issues, and the evidence gathered, were sufficient and appropriate to support the disposition of the case (i.e., by closure, issuance of warning letter, or escalation to Litigation).

In the review of one file, NSSC staff found that while action was taken against a member involved in out-of-province trading, no action was taken in respect of the six APs, including the Chief Compliance Officer, who were involved in the activities that resulted in 80 transactions taking place in 24 accounts of 21 clients. One of the APs had 27 clients, with a total of 35 accounts in six jurisdictions where the AP was not registered. This AP conducted 61 transactions in these accounts.

While it was clear that the member experienced a systemic compliance weakness for such a large number of transactions to occur in out-of-province accounts, NSSC staff question whether the APs should not also be subject to proceedings.

NSSC staff recommendation

While it is clear that there is a systemic problem within the Nova Scotia firm in allowing such numbers of out-of-province trading, NSSC staff expect that APs would also be subject to scrutiny through proceedings where the facts indicate that the situation is more than an inadvertent failure to comply.

Priority: High.

MFDA's response:

The MFDA Enforcement Department maintains screening guidelines and related procedures that provide guidance on whether to escalate cases for the commencement of formal proceedings. These guidelines are based on similar guidelines of other securities regulatory bodies. The guidelines reflect the fact that not all violations, whether deliberate or inadvertent, warrant a public sanction or the expenditure of the level of resources involved in formal proceedings. These guidelines are necessary to ensure the efficient and effective flow of cases through the Department.

The MFDA places a high priority on taking formal action regarding significant and deliberate conduct by Approved Persons in violation of Member supervisory procedures and directions, and has commenced a number of such formal cases recently. However, based on our screening guidelines, the particular case referenced above by NSSC staff did not fall within that group of cases.

Staff comments and follow-up:

NSSC staff has reviewed the screening guidelines and related procedures of the MFDA with regards to determining whether a case should be escalated to formal proceedings. The MFDA may want to give some consideration to more clearly defining these policies in relation to whether proceedings are taken against the firm, the approved person or both as warranted upon the facts. No further follow-up is required.

8. Litigation group

(a) Documented procedures and guidance

Background information

BCSC and OSC staff reviewed the MFDA's documented procedures and guidance relating to the litigation process. These include detailed procedures in the form of a litigation manual, and more informal guidance communications and instructive form precedents.

There are three main types of disciplinary hearings that may be conducted under MFDA By-law No.1: contested hearings, settlement hearings and interim suspension hearings. Disciplinary hearings are conducted before an administrative tribunal. MFDA staff have the burden of proof on the balance of probabilities,

which is the traditional common law standard applied in administrative disciplinary hearings. The MFDA's litigation process is documented in the *Enforcement Department Litigation Manual*. The process is the same in all regions, and each region staffs its own hearing panel with members from their respective regional councils.

Staff findings

BCSC and OSC staff found that the MFDA maintains written procedures and guidance for all aspects of the litigation process, including detailed guidance as to conduct and comprehensive form precedents for use in the litigation process. In addition, there are adequate procedures for regular management review, regional cooperation, new employee training, substantive and organizational file management, and records retention. The MFDA also has a useful summary of prior MFDA decisions available for reference.

Staff recommendations

None.

(b) Litigation process

Background information

The MFDA's litigation process is governed by clear and comprehensive Rules of Procedure, which are publicly available on the MFDA's website. In addition, the various litigation steps are explained to respondents in specific notices from the MFDA Corporate Secretary. Relevant Rules of Procedures are referenced on written decisions of hearing panels.

Staff findings

The Rules of Procedure, their communication to respondents, and their application by MFDA hearing panels are comprehensive and transparent. BCSC and OSC staff are satisfied that the Rules of Procedure provide sufficient guidance to MFDA staff and respondents, and that they are adequate and facilitate an independent, fair hearing process.

Staff recommendations

None.

(c) Review of litigation files

Background information

OSC staff reviewed eight litigation files out of the 41 that were opened and closed between July 2005 and December 2008 to determine whether the matters were conducted in a timely manner and in accordance with the MFDA's Rules of Procedure. As well, OSC staff assessed whether the decisions rendered were in accordance with the MFDA's Penalty Guidelines. At a more general level, staff considered whether there were any systemic weaknesses in the litigation process.

OSC staff also reviewed the files in order to ascertain compliance with T&C #8 in the RO, and in particular the requirement that the MFDA notify both the OSC and the public of the commencement and ultimate resolution of any hearing proceedings.

For the Pacific region, there were three open litigation files during the Review Period. BCSC staff reviewed all three files to determine whether they were conducted in accordance with the MFDA Rules of Procedure.

Staff findings

Overall, OSC staff found that the MFDA's litigation files are remarkably well organized and that activities related to each matter were thoroughly documented. In general, the level of work was adequate for the particular matter, litigation was managed in a timely and efficient manner, and the Rules of Procedure and Penalty Guidelines were followed by both MFDA staff and the hearing panels. In all instances where there was a final determination, the hearing panel's rationale was documented and included useful references to the relevant Rules of Procedure and detailed references to the provisions of the MFDA Rules. OSC staff found evidence of careful management oversight, ensuring appropriate work on the files and consistency in approach across files.

In two of the eight files reviewed, the MFDA proceeded by way of administrative resolution rather than contested hearing. In both instances, the member provided an A&U, which required the member to take substantive steps to remedy the deficiencies that permitted the problematic activity to arise in the first place.

In those instances, the Enforcement Counsel followed up with the member to ensure that it complied with the terms of the A&U. Both of these administrative resolutions were proper and appropriate in the circumstances. These cases are instances in which the MFDA was able to work with members to develop a practical and lasting solution to a systemic problem, to the benefit of investors generally.

For the Pacific region, BCSC staff found the three files were generally well documented and well organized. However, the following anomalies were noted. In one file, the Litigation Process List was missing from the main correspondence folder. Also in the same file, there were two signed versions of the Enforcement Counsel Recommendation Report. Both reports bore the same date of signature. In all other respects, the files followed the established procedures.

Staff recommendations

None.

MFDA's response:

We will review the current procedures with staff to ensure that these situations are avoided in future.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response.

E. Compliance

1. Introduction

The MFDA Compliance Department's primary responsibility is to monitor members' compliance with the MFDA requirements. In carrying out this responsibility, the MFDA is required by T&C #7 of the RO to conduct periodic examinations of its members and APs in order to ensure compliance with the MFDA Rules. T&C #7 also establishes certain reporting obligations by the MFDA to the OSC. For example, the MFDA is required to report instances where members trigger early warning thresholds and any conditions which, in the opinion of the MFDA, could give rise to payments made out of the MFDA Investor Protection Corporation (MFDA IPC).

The Compliance Department has two groups: Sales Compliance and Financial Compliance. The Sales Compliance group's key responsibility is performing onsite sales and business conduct examination of members. The Financial Compliance group's responsibilities are to review and analyze members' financial filings to ensure each member maintains and reports adequate capital, in accordance with the MFDA Rules; to conduct onsite financial compliance examinations of members; and to review working paper files of the members' auditors. Since the Financial Compliance group is only located at the MFDA's head office, it is responsible for ensuring financial compliance of the MFDA membership nationally.

2. Purpose and scope

The main objectives of this part of the oversight review were to review and evaluate the structure and resources, including staffing, of the MFDA's Compliance Department; to evaluate the adequacy of the performance benchmarks used by the Sales and Financial Compliance groups; to assess the adequacy, timeliness, and quality of compliance examinations and reviews of financial filings; and to assess whether matters that should be reported to the OSC, as required by T&C #7, were promptly reported.

In order to accomplish these objectives, OSC staff reviewed the relevant provisions of the MFDA's By-law No. 1, as well as relevant MFDA Rules. OSC staff also reviewed various internal policies and procedures documents, interviewed staff of the MFDA's Sales and Financial Compliance groups and reviewed samples of examination files to determine the adequacy, timeliness and quality of compliance examinations.

ASC staff reviewed the MFDA's Financial Compliance group to determine whether it has the resources and processes in place to ensure it performs its regulatory functions effectively and efficiently and that it is complying with the spirit and letter of the RO.

To accomplish this, ASC staff held interviews with (i) the VP of Compliance, and (ii) the Director of Financial Compliance. ASC staff also reviewed MFDA policies and procedures and a sample of financial examination files.

3. Department structure

Background information

OSC staff discussed the Compliance Department's structure with management and reviewed its organizational chart to gain an understanding of the staffing and reporting structure of this department.

The Sales Compliance group consists of compliance officers (COs) who report to their compliance managers, who in turn report to the Director of Sales Compliance. The Director of Sales Compliance reports to the Vice President of Compliance, Communications & Membership Services (VP of Compliance).

The Financial Compliance group has financial compliance examiners (FCEs) who report to financial compliance managers, one director reporting to the VP of Compliance, and one administrator.

Staff findings

OSC staff had no concerns regarding the adequacy of the department's reporting structure. For the Sales and Financial Compliance groups, there is an adequate management to staff ratio, which ensure that sufficient guidance is available to staff.

Staff recommendations

None.

4. Sales Compliance group

(a) Staffing resources and training

Background information

OSC staff met with MFDA management to discuss staffing resources and were advised that, as of December 31, 2008, the Sales Compliance group had 31 employees, consisting of seven compliance managers and 24 COs. In management's view, the staffing level in Sales Compliance is sufficient to meet the current workload.

Initial training provided to staff involves a combination of group training sessions, self-study, and on-the-job training. Ongoing training is also provided, through monthly lunch-and-learn sessions for Sales Compliance staff wherein discussions are held regarding various issues including new MFDA Rules and regulations, emerging trends and new investment products being used in the industry.

Staff findings

During the Review Period, the number of new hires generally exceeded the number of resignations and/or terminations, therefore there was no shortage of staff. In addition, during the Review Period, the Sales Compliance group has consistently met its benchmarks (please see 4(b) for additional detail), which also suggests that the staffing levels are adequate and that the MFDA's Sales Compliance group has sufficient resources to handle its current workload. In addition, there is a budgeted

headcount increase to meet future resource requirements. OSC staff had no concerns with the staffing and turnover levels in Sales Compliance.

OSC staff's review of the MFDA's documented training materials indicates that they were adequate and comprehensive. The training materials include, among others, guidance on file documentation, documentation of examination findings and recommendations to address them, case studies on various topics (i.e., accredited investors, suitability), and updates regarding new MFDA Rules and/or Policies. The initial and ongoing training processes also appear adequate.

Staff recommendations

None.

(b) Benchmarks

Background information

OSC, NBSC, and NSSC staff discussed the benchmarks used by the Sales Compliance group, as well as the processes in place to monitor adherence with the established benchmarks with management. OSC, NBSC, and NSSC staff also reviewed sales compliance policies and procedures. As documented in the materials provided by the MFDA to the CSA in preparation for the oversight review, the benchmarks for issuing sales compliance reports for the second review cycle in the Review Period were:

- 70% of the reports should be issued within 15 weeks of substantial completion of the fieldwork; and
- the remainder should be issued within 22 weeks of substantial completion of the fieldwork.⁶

Substantial completion of fieldwork occurs when COs complete their initial onsite visit and leave the member's premises, and receive the initial documentation to complete their examination procedures. In certain circumstances, it may differ from the end of the onsite visit.

OSC, NBSC, and NSSC staff also reviewed information regarding the sales compliance examinations conducted during the Review Period, such as timelines showing the dates the fieldwork started and ended, and dates the reports were issued. OSC, NBSC, and NSSC staff reviewed this information to determine whether the final reports were issued within the established benchmarks.

⁶ OSC, NBSC and NSSC staff were informed that the MFDA has decided to revise and tighten one of its current benchmarks to require it to issue 80% of the reports within 15 weeks of the substantial completion of fieldwork. This will be effective for examinations commencing in 2009, the start of the third review cycle. During the first 6 months of the Review Period, which was the last 6 months of the first review cycle, the compliance benchmark was 60% within 15 weeks of fieldwork end date and 100% within 26 weeks.

Staff findings

OSC staff's review of internal statistics showing the dates the fieldwork ended and the dates the reports were issued indicated that the majority of the final reports were issued between the 13th and 15th week after the end of fieldwork and, on average, reports were issued within 13 weeks after the end of fieldwork. Approximately 94% of the reports were issued within 15 weeks of the end of fieldwork. NSSC staff found that final reports for members with head offices in Nova Scotia were issued between 10 and 15 weeks from the end of fieldwork. NBSC staff found that final reports for members with head offices in New Brunswick were issued between 5 and 14 weeks from the end of fieldwork. Therefore, the benchmarks were consistently met during the Review Period. Compliance with benchmarks is monitored on a monthly basis, and the benchmarks are assessed and updated at the beginning of every new examination cycle. This process is adequate.

OSC, NBSC and NSSC staff found, however, that there were inconsistent references to the measurement start date for Sales Compliance benchmarks. For example, written policies and procedures such as those included in the MFDA's *Compliance Officer Reference Manual* referred to the completion of fieldwork, while preparatory materials provided to the CSA for this oversight review referred to substantial completion of fieldwork.

Staff recommendations

The MFDA should clarify the benchmarks for issuing sales compliance examination reports and ensure that they are consistently documented and measured. If benchmarks are tracked from the time of substantial completion of fieldwork, the MFDA should ensure that its benchmarks remain appropriate and accurately reflect the time required to issue examination reports.

Priority: Medium.

MFDA's response:

The Compliance Officer Manual and other internal materials intentionally referred to the benchmark being measured from the completion of fieldwork because we stress with our Compliance Officers the importance of completing all examination procedures in the field and do not wish to create the impression for Compliance Officers that the benchmark can be extended in the normal course. It is only in limited circumstances where there is: (i) management approval; and (ii) a significant delay in receiving key documents from the Member, that the fieldwork completion date can be extended beyond the date MFDA staff leaves the Member's premises. We adopted this approach because there are situations where staff is not provided sufficient information to complete the examination and the benchmark may not be met for reasons beyond our control.

In the limited cases where the substantial completion of fieldwork differs from the date MFDA staff leaves the Member's premises, the Manager must note this in our examination tracking system and the system does not allow the Manager to proceed unless they put in an explanation for the delay. Only Managers can extend the fieldwork

in the examination tracking system. Senior Management reviews this information to ensure that the substantial completion of fieldwork only differs from the date MFDA staff leaves the Member's premises in rare and appropriate circumstances.

Nevertheless, to address CSA staff concerns, we will ensure benchmarks are measured from the date staff leaves the Member's premises.

Staff comments and follow-up:

MFDA's response is adequate. We ask that the MFDA advise OSC, NBSC and NSSC staff when the benchmarks are clarified.

(c) Examination process

(i) Documented procedures and guidance

Background information

OSC staff reviewed the policies and procedures used by the Sales Compliance group, including the MFDA's *Compliance Officer Reference Manual*.

Staff findings

The MFDA's *Compliance Officer Reference Manual* provides adequate guidance with respect to the process for conducting sales compliance field examinations. There is also an adequate process in place to update the policies and procedures periodically. The most notable update during the Review Period was the addition of procedures to examine members' compliance with MFDA's Policy 6 *Information Reporting Requirements* issued on July 3, 2007 and MR-0059 *Complaint Handling Obligations* issued on December 20, 2006.

Staff recommendations

None.

(ii) Member selection process for examinations

Background information

OSC, NBSC, and NSSC staff discussed the member selection process for sales compliance examinations with management.

The Sales Compliance group conducts sales compliance examinations for all members within a three-year cycle. Within each cycle, the MFDA prioritizes members for review by applying the results of its Compliance Risk Model (Risk Model), a model used to assess the overall risk of members and rank them against each other based on their risk. Generally, members with the highest risk score are scheduled ahead of those with lower scores.

In addition to the Risk Model, the MFDA also considers other factors when selecting and scheduling sales compliance examinations, such as availability of staff resources, the date of the last examination, number of complaints relating

to the members, specific information from the securities commissions (if any), and the nature of the members' business activities.

In selecting and scheduling branch offices for review, the MFDA considers factors such as the member's risk ranking, the type of dealer (i.e., national dealers versus dealers with offices in only one jurisdiction), the number of complaints relating to the branch, specific information received from the securities commissions (if any), and the size of the branches.

Staff findings

Generally, OSC staff did not have concerns with the MFDA's processes for selecting and scheduling sales compliance examinations of members' head offices. NBSC and NSSC staff also noted that the MFDA has increased its presence in their respective provinces in terms of the number of branch examinations performed. However, NBSC and NSSC staff believe that, notwithstanding the risk based approach to selecting and scheduling branch examinations, the MFDA should ensure that it conducts an appropriate number of branch office reviews in Nova Scotia and New Brunswick.

NBSC and NSSC staff recommendations

As the capital markets in New Brunswick and Nova Scotia primarily consist of branches and sub-branches of members, the MFDA should ensure that it conducts an appropriate number of New Brunswick and Nova Scotia branch office examinations every year.

Priority: High.

MFDA's response:

We acknowledge the importance of performing branch examinations. We will continue our efforts to balance the need to select branches based on risk to ensure we fulfill our national investor protection mandate, while also meeting the expectations of the various provincial securities regulatory authorities to perform an appropriate number of examinations in each jurisdiction.

Staff comments and follow-up:

NBSC and NSSC staff are satisfied with the MFDA's response. No further follow-up is required.

(d) Examination program

Background information

OSC staff reviewed the MFDA's sales compliance examination program. During the Review Period, the MFDA updated the compliance examination program to include procedures to check members' compliance with Policy 6 *Information Reporting Requirements* and MR-0059 *Complaint Handling Obligations*.

Staff findings

The MFDA's sales compliance examination program is comprehensive and updated on a regular basis with examination procedures that address new MFDA Rules and regulatory notices.

Effective January 2009, the start of the MFDA's third review cycle, the MFDA made further changes to the sales compliance program. Such changes included the removal of examination steps that required MFDA staff to review, at a high level, the members' DRPs. The MFDA will continue to request and review this information for new members. However, and especially in light of the recent outbreak of the H1N1 virus, OSC staff are concerned that these steps have been eliminated for existing members.

Staff recommendations

The MFDA should maintain procedures to determine, at a high level, that all members continue to have DRPs designed to ensure that clients' transactions can be conducted with minimal disruption. Such procedures should, at a minimum, ensure that the members' DRPs continue to be in place, that they continue to be appropriate in situations where there have been material changes to the members' operations, and that they are tested on an annual basis.

Priority: High.

MFDA's response:

In order to further focus the examination program on key risk areas, it is necessary to eliminate testing in lower risk areas. At the end of the second cycle of examinations, we carefully examined all of our examination procedures with a view to further focusing our approach on key issues around suitability and supervision.

Business Continuity Planning is an area where we felt the risks had been adequately addressed and, therefore, could be eliminated from the examination procedures for established Members based on several considerations. These considerations included the following facts: (i) the significant majority of assets are held in client name and can be accessed by investors directly with the fund companies; (ii) we had issued policy guidance to Members and had tested all Members in the second cycle of examinations; and (iii) we would continue to test Business Continuity Planning for any new Members. We also specifically advised CSA Oversight Group of this change and other changes to our examination program prior to implementation and received no objection or feedback.

We understand the "high level" procedures recommended by OSC staff are to make inquiries to determine if the Member has a DRP, if it was tested and if it continues to be appropriate where there are changes to Member operations. We can accomplish this more effectively and more frequently through other MFDA processes, rather than incorporating procedures in our examination program and diverting resources from key suitability and supervision issues. We will include additional questions with respect to

Members' business continuity planning in our annual survey and perform subsequent follow-up procedures where necessary.

Staff comments and follow-up:

MFDA's response is adequate. We ask that the MFDA provide to OSC staff, for their review, the proposed questions dealing with the Members' DRP that will be included in the annual survey to the members.

(e) Review of sales compliance examination files

Background information

OSC staff reviewed 10 of 74 sales compliance examination files completed during the Review Period for members with head offices in Ontario. The sample included examinations of head offices and branch offices.

NSSC staff were informed that, during the Review Period, the MFDA started and completed two sales compliance examinations of members with head offices in Nova Scotia. NSSC staff reviewed both these files. The MFDA also reviewed 11 Nova Scotia branches of MFDA dealers of which the NSSC reviewed five.

For the Review Period, NBSC staff reviewed all of the completed sales compliance examination files relating to the three members that have head offices in New Brunswick. The sample included examinations of head offices and branch offices. NBSC staff also reviewed four other sales compliance examination files conducted on branch offices located in New Brunswick of members with head offices located in other jurisdictions.

Staff findings

The review of the sampled sales compliance examination files shows that the files were generally well documented, and the level of analysis was thorough. The files reviewed contained planning memoranda and evidence of adequate research on the member, which were prepared prior to the onsite visit. Sample sizes chosen for testing procedures were explained and justified, and deficiencies noted were referenced to supporting documentation in the file. In addition, findings from previous examinations that required follow-up were properly identified and included in the report issued to the member. All of the files reviewed contained evidence of the manager's review. OSC, NBSC and NSSC staff found that the files were completed within a reasonable amount of time, taking into consideration the size of the member firm and the number of branch offices reviewed. In all cases, the internal benchmarks were met.

In one file reviewed by NSSC staff, there was evidence of questionable leverage for two clients. Specifically, the net worth of the individuals was 95% and 100%, respectively, of the leverage amount, and the MFDA had found evidence that proceeds from dividends from the leveraged investment were used to pay back the loan. Subsequent correspondence from the MFDA to the member indicated that a phone conversation took place between the MFDA and the member's staff in which

the member indicated that they would consider contacting the two clients to assess their understanding of the risks inherent in the leveraging strategy recommended by the AP. However, NSSC staff are concerned that the MFDA did not provide clear direction to the member as to how to resolve this issue.

In one file reviewed by NBSC staff, verification of client identity, which had been noted as a deficiency in the previous MFDA examination, reoccurred in the subsequent review. However, the client accounts in question were actually registered plans that were exempt from the FINTRAC client identity requirements. NBSC staff was informed that because checking for client identity is part of the MFDA's testing template, the template was marked as a deficiency. NBSC staff are concerned that the MFDA raised the deficiency without having considered all the relevant facts.

NSSC staff recommendations

The MFDA should ensure that it provides specific direction to members on resolving suitability issues.

Priority: High.

MFDA's response:

We agree we should try to provide as much direction as possible to Members on addressing deficiencies raised in an examination. In this regard, we have provided extensive training to staff and guidance to Members with respect to leverage suitability, including MR-0069 "Suitability Guidelines", Bulletin #0355-C "Common Sales Compliance Deficiencies and Appropriate Corrective Action" and Bulletin #0431-C "Leverage Supervision Guide".

Staff comments and follow-up:

NSSC staff are satisfied with the MFDA's response. No further follow-up is required.

NBSC staff recommendations

The MFDA should ensure that all factors and facts are considered before deficiencies noted in sample testing are reported to the member.

Priority: High.

MFDA's response:

We agree that this matter should not have been raised in the examination report. This was one specific matter raised in an examination 4 years ago and was quickly resolved with the Member.

Since the time of this examination, we have had several training sessions with FINTRAC on FINTRAC requirements. Additionally, in conjunction with the publication of the updated FINTRAC Guideline 6e, we added additional guidance to the examination

program, including specifically noting that the client identification requirements do not apply to registered accounts.

Staff comments and follow-up:

NBSC staff are satisfied with the MFDA's response.

5. Financial Compliance group

(a) Staffing resources and training

Background information

OSC staff discussed the current staffing resources as well as the process to review the adequacy of staff resources with MFDA management. OSC staff also reviewed a report on Financial Compliance staffing, in order to assess the staffing levels and turnover rates during the Review Period.

The Financial Compliance group has a total of 26 staff, including one director, six managers, 13 FCEs, five senior FCEs, and one administrator. Staffing levels are reviewed annually at the budget time, when the department assesses workloads and responsibilities.

Training is done initially on hiring and on an ongoing basis. Generally, FCEs spend the first week of their employment in the office becoming familiar with the MFDA Rules, systems, internal procedures, and the guidance materials in the training binder. In addition, the MFDA offers a two-day annual training session on regulatory issues for Compliance, Enforcement and Policy staff from all the MFDA offices, in which FCEs also participate. This consists of presentations from external speakers and group discussions on ongoing industry issues. There are also informal monthly lunch-and-learn sessions.

OSC staff discussed staff qualifications and training with MFDA management and reviewed the MFDA's internal procedures for training new Financial Compliance staff, as well as the binder of policies, procedures and training materials given to new FCEs.

Staff findings

OSC staff's review of turnover rates indicated that the turnover was relatively high in 2006, but appeared to have stabilized thereafter. Discussions with management indicated that the larger than usual turnover in 2006 was mainly due to the strong economy at that time and staff's departure for other opportunities. At present, turnover is not a problem and, despite acknowledged difficulty in finding staff with the right experience and qualifications, the group is currently at full complement. MFDA management is comfortable that the current staffing level is sufficient to handle the existing workload. Each Financial Compliance staff currently looks after approximately eight members, which appears to work well.

OSC staff have no concerns with the Financial Compliance staffing level. In addition, the MFDA's training process and materials also appear adequate.

Staff recommendations

None.

(b) Benchmarks

Background information

OSC staff reviewed the internal benchmarks used by the Financial Compliance group and discussed them, as well as the process for monitoring their continuing adequacy, with MFDA management. OSC staff also reviewed reference manuals used by the Financial Compliance group, which describe the benchmarks used.

As discussed with management, the benchmarks used by the Financial Compliance group for issuing examination reports during the Review Period⁷ were as follows:

- 70% of the reports must be issued within 15 weeks of substantial completion of fieldwork.
- 100% of the reports must be issued within 22 weeks from substantial completion of fieldwork.

The benchmarks used for the Financial Compliance group for desk reviews of members' Financial Questionnaire and Reports (FQRs) are as follows:

- unaudited monthly filings must be reviewed within five business days of the filing due date (which is 20 business days from month end).
- audited annual filings must be reviewed within one calendar month of the filing due date for high risk members⁸ and members in early warning, and within three calendar months of the filing due date for all other members (annual audited filings are due within 90 days of a member's fiscal year end).

OSC staff also reviewed statistical data provided by MFDA staff to assess whether the benchmarks were met. Such statistical data indicate the dates of the start and end of fieldwork, dates of substantial completion of fieldwork, and dates the reports were issued.

Staff findings

OSC staff found that the MFDA has processes in place to monitor whether the benchmarks are met, and whether they are appropriate. When these benchmarks are not met, MFDA staff are required to document the reasons for the variance.

⁷ The benchmarks were subsequently reviewed, and the applicable benchmark for issuing examination reports for 2009 is to issue 80% of the reports within 15 weeks of substantial completion of fieldwork, and 100% of the reports within 20 weeks.

⁸ High risk members are generally members that are or have been designated in early warning, or members for which significant issues were found during onsite examinations.

However, OSC staff found that the descriptions of benchmarks used for issuing examination reports were inconsistent. For example, discussion with management indicated that they were measured from the end of substantial completion of fieldwork, while internal reference manuals indicated that they were measured from the end of fieldwork.

OSC staff's review of statistics provided by the MFDA indicated that, if time to issue examination reports is measured from the end of fieldwork, on average during the Review Period, only 58% of the reports were issued within 15 weeks and 12% of the reports took longer than 22 weeks to be issued. Most delays were related to reviews carried out in 2006, a year when the group experienced unusually high staff turnover and, consequently, delays in issuing the field reports. The performance of the Financial Compliance group has since improved, and the MFDA met the 15-week benchmark for 64% of the reports in 2007 and for 76% of the reports in 2008.

OSC staff also found that, if time to issue examination reports is measured from the end of substantial completion of fieldwork, on average during the Review Period, reports were issued within 15 weeks, and therefore the benchmark for issuing reports was met, 94% of the time. This suggests that, if measured from the end of substantial completion of fieldwork, the benchmarks for issuing of examination reports could be revised, with a view of tightening them further.

OSC staff also found that, although the MFDA started to review auditors' working papers in late 2006, there are no benchmarks for auditor working paper reviews.

OSC staff noted that, with the existing benchmark for desk review of members' FQRs, annual audited filings of members that are not considered high risk, could be reviewed up to six months from their fiscal year end. OSC staff are concerned that this may lead to significant issues not being uncovered until six months after their occurrence.

Staff recommendations

The MFDA should clarify the benchmarks for issuing financial compliance examination reports and should ensure that they are consistently documented and measured. They should also reassess its benchmarks to ensure they remain appropriate and accurately reflect the time required to issue examination reports.

Priority: Medium.

MFDA's response:

The Financial Examiner Reference Manual and other internal materials intentionally referred to the benchmark being measured from the completion of fieldwork because we stress with our Financial Examiners the importance of completing all examination procedures in the field and do not wish to create the impression for Financial Examiners that the benchmark can be extended in the normal course. It is only in limited circumstances where there is: (i) management approval; and (ii) a significant delay in

receiving key documents from the Member, that the fieldwork completion date can be extended beyond the date MFDA staff leaves the Member's premises. We adopted this approach because there are situations where staff is not provided sufficient information to complete the examination and the benchmark may not be met for reasons beyond our control.

In the limited cases where the substantial completion of fieldwork differs from the date MFDA staff leaves the Member's premises, the Manager must note this in our examination tracking system and the system does not allow the Manager to proceed unless they put in an explanation for the delay. Only Managers can extend the fieldwork in the examination tracking system. Senior Management reviews this information to ensure that the substantial completion of fieldwork only differs from the date MFDA staff leaves the Member's premises in rare and appropriate circumstances.

Nevertheless, to address CSA staff concerns, we will ensure benchmarks are measured from the date staff leaves the Member's premises.

Staff comments and follow-up:

MFDA's response is adequate. We ask that the MFDA advise OSC staff when the benchmarks are clarified.

The MFDA should develop an appropriate benchmark for the review of members' auditors' working papers.

Priority: High.

MFDA's response:

MFDA staff will establish benchmarks for issuing auditor working paper review letters that are consistent with the compliance examination report benchmarks.

Staff comments and follow-up:

OSC staff are satisfied with the MFDA's response.

The MFDA should consider reviewing its benchmark for desk reviews of members that are not high risk to ensure that issues are uncovered and dealt with on a timely basis.

Priority: Medium.

MFDA's response:

Each Member provides more timely financial information to the MFDA relating to the year end capital position through the unaudited monthly financial report that is required to be submitted within 20 business days of the month end. The annual financial information has been subject to audit by an external party who has agreed to comply with MFDA requirements, which include Rule 3.6.6, the requirement to report to the MFDA a

material breach by a Member of Rules pertaining to the calculation of the Member's financial position, handling and custody of securities and maintenance of adequate records.

The MFDA has compared its benchmark to other regulators and believes it continues to be appropriate.

Staff comments and follow-up:

MFDA's response is adequate. To the extent that the desk reviews of members' Monthly Financial Reports are completed and issues dealt with on a timely basis, OSC staff accept MFDA's explanation that the current time frame for desk reviews of the audited FQRs for non-high risk members remains appropriate at this point in time.

(c) Financial filing review process

(i) Process for review of FQRs

Background information

OSC staff discussed the processes for review of members' FQRs with management and reviewed various procedures, including the *Financial Examiner Reference Manual*, as well as relevant MFDA Rules and Internal Policy Statements.

Staff findings

Most of the manuals and internal procedures are comprehensive and contain clear, specific steps to provide proper guidance to the FCEs involved in reviews of FQRs. OSC staff also found that, generally, the MFDA reviews its internal procedures regularly and constantly updates the policies and procedures.

Staff recommendations

None.

(ii) Review of FQR files

Background information

OSC staff reviewed 15 FQR files completed by the MFDA during the Review Period to assess if the MFDA reviewed the members' monthly and annual financial filings adequately and on a timely basis. OSC staff also assessed if the files were properly documented, and whether the issues were adequately identified and resolved. The sample selected included small, large, bank-owned, independent, introducing, and carrying dealers; dealers that failed to file any financial, operational or other reports; dealers for which early warning thresholds were triggered; or dealers where the MFDA identified with potential claims to the MFDA IPC. The sample also included members with head offices in and outside Ontario.

Staff findings

OSC staff were generally satisfied with the quality and organization of the FQR files. Most files were well documented, and issues were properly identified and resolved.

However, OSC staff noted that, in a few instances, the hard copy filings of the annual FQR⁹ were over 30 days late. While MFDA staff monitor receipt of the electronic version of the filing to ensure that it is filed on time, no reminders are sent to members when the paper filing is late. OSC staff are concerned with the delays in filing the signed paper copy of the annual audited FQR, but acknowledge that the MFDA is in the process of developing a notice on overdue paper filings and plans to send reminders to members when the paper filings are late.

OSC staff also found that some FQRs produced by the members' auditors did not appear to be adequately documented. For example:

- the Notes and Disclosures did not include descriptions of significant accounting policies outlining the basis of reporting Statements of Assets and Liabilities, basis of revenue recognition or basis for evaluating financial instruments.
- some of the financial statement notes appeared to have been prepared for the member's own GAAP financial statements, but did not conform to the MFDA's presentation requirements of the FQR or its Rules (e.g., one FQR note indicated that commission revenue is recorded at the time of trade settlement, which is a clear departure from the MFDA's requirements).
- in one instance, the date was missing on the signoff page on the Part I – Auditors' report.
- statement dates on the Part I Auditors' report, as well as answers to the Partners and Directors' certificate were pencilled in rather than properly entered into the system.
- the date on the Partners and Directors' certificate was subsequent to the FQR submission date, which indicated that the auditor did not ensure that this certificate was signed off and dated before the completion of the audit.

Members' auditors are required to know the relevant rules and requirements, specifically Rule 3.6 *Audit Requirements* which outlines specific audit engagement requirements to be performed by the external auditor of a MFDA member. OSC staff noted that the MFDA is aware of the challenges it is facing regarding auditors' proficiency in the MFDA's Rules and requirements and recognizes the importance of educating and updating members' auditors on them. For example, the MFDA has recently started to conduct seminars for the auditors.

⁹ Members are required to submit two complete and appropriately signed paper versions of the audited FQR to the MFDA, in addition to the audited FQR electronic filing.

Staff recommendations

OSC staff encourage the MFDA to continue its efforts to educate and enhance the members' auditors' proficiency in MFDA Rules.

Priority: Medium.

MFDA's response:

We will continue to provide information and sessions for auditors to the extent possible.

Staff comments and follow-up:

MFDA's response is adequate.

Staff recommendations

The MFDA should develop minimum requirements or guidance for the information to be included in the Notes and Disclosures attached to the annual audited FQR.

Priority: Medium.

MFDA's response:

Minimum requirements for financial statement note disclosure are established by the Canadian Accounting Standards Board ("AcSB") and have not been prescribed by the MFDA. The MFDA only establishes unique or different standards with respect to its financial requirements where a specific regulatory concern has been identified. The MFDA has not established any unique note disclosure requirements, but rather accepts the standards established by AcSB. The MFDA does not feel it is appropriate to spend staff resources on educating auditors on basic accounting standards that are not unique to the MFDA. Member auditors are accredited licensed accounting professionals who are required to comply with Canadian auditing and accounting standards in the conduct of their engagements. However, if we find common deficiencies in this area, we can communicate these issues and provide guidance by way of a Bulletin to Members and Member auditors or auditor feedback sessions.

Staff comments and follow-up:

MFDA's response that it will provide guidance to members and their auditors when common deficiencies are identified is adequate. OSC staff note that such guidance was provided in MFDA's Bulletin #0428-C of March 22, 2010 *Auditor Working Paper Review - Common Deficiencies*.

Staff recommendations

The MFDA should complete and implement the process to follow-up and ensure that the signed, hard copy version of members' audited annual filings are filed on a timely basis.

Priority: Medium.

MFDA's response:

MFDA staff agrees that a process should be implemented to follow-up and ensure that the signed hard copy version of Members' audited annual filings are filed on a timely basis. Therefore, this process has since been implemented.

Staff comments and follow-up:

OSC staff are satisfied with the MFDA's response.

(d) Financial compliance examination process

(i) Documented procedures and guidance

Background information

OSC staff obtained and reviewed the procedures relevant to field examinations and discussed examination procedures and processes with the MFDA's management.

Staff findings

OSC staff found that the MFDA has documented procedures that provide adequate guidance to FCEs regarding the processes to conduct field examinations. Such procedures give guidance on the frequency of examinations, scheduling and staffing, and planning and conducting field reviews. They also describe benchmarks for issuing examination reports and give guidance on enforcement matters. Discussions with management indicated that the MFDA constantly improves and develops its procedures and policies.

Staff recommendations

None.

(ii) Member selection process for financial compliance examinations

Background information

The Financial Compliance group performs financial examinations of all Level 4 dealers¹⁰ annually. Level 2 and 3 dealers¹¹ are scheduled for examination within a three-year examination cycle, and prioritized for review based on members' risk, staff resources, and referrals from other MFDA departments.

OSC staff reviewed the examination schedule, as well as statistics provided by the MFDA indicating members that were designated in early warning.

¹⁰ These are dealers that hold client securities or other property in nominee name accounts or in physical storage.

¹¹ Level 2 dealers are dealers that do not hold client cash, securities or other property. They operate in a client name environment and do not use a trust account to hold client cash. Level 3 dealers are dealers that hold client cash in a trust account, but do not hold client securities or other property. They operate in a client name environment, and use a trust account to hold client cash.

Staff findings

In OSC staff's view, the selection and review of Level 4 dealers on an annual basis is adequate.

However, in light of the risk that these dealers pose, OSC staff question whether a three-year interval for review of Level 2 and 3 dealers is sufficient. For example, OSC staff's review, of the statistics provided by the MFDA, shows that a large percentage of members in early warning are Level 2 and 3 dealers.¹² Furthermore, OSC staff found that, since 2005, out of 67 firms that had been designated in early warning, 79% were Level 2 and 3 dealers, and only 21% were Level 4 dealers. Also, statistics indicate that, out of six member firms that were insolvent, five were Level 2 and 3 dealers and only one was a Level 4 dealer. These statistics indicate that Level 2 and 3 dealers may pose the same, if not higher, risk of experiencing operational and financial difficulties, and therefore a three-year interval for their financial compliance review may be insufficient. OSC staff acknowledge that these dealers are also subject to sales compliance reviews, and issues would be brought to the attention of Financial Compliance staff at that time; however, sales compliance reviews are also scheduled within a three-year cycle.

Staff recommendations

The MFDA should reassess its practice of performing an examination of Level 2 or 3 dealers within a three-year cycle and consider whether higher risk Level 2 or 3 dealers, such as dealers with operational and financial difficulties, should be subject to more frequent financial compliance examinations.

Priority: Medium.

MFDA's response:

MFDA staff monitors and assesses the financial position of all dealer levels on a monthly basis through the review of Members' monthly financial reports. Regardless of the established examination cycle and/or scheduled examination date for any dealer, where financial or operational concerns come to the attention of the MFDA through examination filings or otherwise, on-site examinations are immediately performed targeting the risks or potential risks identified. In some cases, Financial Compliance performs these targeted examinations in conjunction with staff from Sales Compliance or Enforcement, depending upon nature of the regulatory concerns. Additional regulatory oversight, which may include recurrent on-site examinations, is conducted until staff is satisfied that the risks have been properly addressed. These targeted or non-routine examinations are performed in addition to the routine scheduled examinations.

We believe performing financial examinations of Level 2 and 3 dealers on a routine basis within our examination schedule and on an exceptional or targeted basis where concerns are identified is the most effective use of MFDA resources.

¹² For example, at December 31, 2008, 94% of members designated in early warning were Level 2 and 3 dealers and, out of a total of 17 dealers in early warning, only one was a Level 4 dealer.

Staff comments and follow-up:

MFDA's response is adequate. We understand that the MFDA did conduct additional on-site financial compliance examinations for members that had operational and financial difficulties.

(e) Financial compliance examination program

Background information

OSC staff reviewed the examination program, used by the Financial Compliance group to perform their field and in-office reviews of FQRs, to assess the adequacy of procedures and guidance provided to staff. OSC staff also reviewed a sample of financial compliance examination files to determine whether the procedures were followed.

Staff findings

In general, the examination programs are comprehensive and include specific and detailed instructions and guidance to FCEs. However, OSC staff noted some areas that may require further clarification:

- Procedure # 9 under Statement A of the Annual Audited FQR Review Program and Procedure 2 under Statement A of the Unaudited FQR Review Program both require FCEs to perform calculations to assist in the identification of significant issues, but there is no guideline on what calculations are required or what qualifies as a significant issue. OSC staff's review of the financial compliance examination files showed that, in reply to this examination step, FCEs attached a simple notation "done" without identifying what calculations had been performed.
- The in-office review program does not have procedures to require MFDA staff to check whether receivables included in Other Allowable Assets (OAA) are from Acceptable Entities¹³ only. OSC staff's review of FQR files indicated there may be some confusion at the member level on what is an Acceptable Entity, which would justify either specific procedures to require FCEs to follow-up and ensure whether OAAs are from Acceptable Entities, or instructing members to provide more information in their FQR filings to enable FCEs to make the assessment. OSC staff noted that some FCEs already follow-up with the member, so the MFDA could consider standardizing this process.
- The field examination program did not have steps requiring FCEs to check for improper netting of general ledger account balances. OSC staff's review of field examination files showed that members netted accounts balances in suspense, receivable and payable accounts when compiling FQRs, which may result in incorrect calculation of risk adjusted capital (RAC).

¹³ Acceptable Entities are defined in Form 1 Financial Questionnaire and Report and generally include certain financial institutions and other creditworthy entities.

Staff recommendations

The MFDA should consider enhancing its existing examination procedures with clear specific steps addressing the findings above. The above suggestions are elaborations on the current review procedures, but clear specific steps may assist and act as a reminder to FCEs when conducting in-office reviews.

Priority: Medium.

MFDA's response:

We will provide more guidance to staff regarding "significant" issues.

While some Members may not have a full understanding of MFDA requirements, it is not necessarily representative of all Members. Adding an additional step in the monthly desk review program requiring staff to check whether receivables included in Other Allowable Assets are from Acceptable Entities goes beyond a desk review process. It is unnecessary to impose an investigatory standard for all Members reporting Other Allowable Assets regardless of materiality or proficiency of the Member. Our analytical review steps prompt staff to identify any material balances that have an impact on regulatory capital requiring them to be followed up and addressed with the Member.

MFDA staff agrees with OSC staff's recommendation to enhance the examination program to clarify that staff is to review suspense accounts for improper netting of receivable and payable balances. Additional steps to the examination program have been added to the Regulatory, Nominee Name and Trust sections of the program to require staff to consider whether the Member has incorrectly netted balances that should be reported on a gross basis on the FQR.

Staff comments and follow-up:

MFDA's response is adequate. We ask that the MFDA provide OSC staff with a revised copy of the examination program by September 30, 2010.

(f) Review of financial compliance examination files

Background information

OSC staff selected a sample of 10 financial compliance files for review. The sample included files for small, large, bank-owned, independent, introducing, and carrying dealers; dealers that failed to file any financial, operational or other reports; dealers for which early warning thresholds were triggered; and dealers where the MFDA identified that payments could be made out of the MFDA IPC. The sample included both members with head offices in Ontario and members with head offices outside Ontario.

In addition, OSC staff also performed limited review procedures on a sample of two MFDA dealers. The aim of this review was to assess the quality of the financial compliance examinations by determining whether the work done by MFDA staff was adequate and timely, and file documentation proper and complete. The

objective was also to determine whether matters that should be reported to the Commission under T&C #7(C) of the RO were, in fact, promptly reported.

ASC staff reviewed a sample of financial compliance files of Alberta members. ASC staff's findings are summarized in II.E.5(f)(iii).

(i) File documentation

Staff findings

Overall, files were well structured and organized. OSC staff noted that the structure and organization of files had recently been standardized. OSC staff was informed that file documentation is regularly updated with new checklists and forms to close off gaps noted in the examination process.

However, in one file, OSC staff noted that, while documents supporting a finding included in the examination review report had been adequately collected by the FCE, they were not included in the field examination files.

Staff recommendations

The MFDA should review and tighten the standards and procedures on file documentation to ensure that materials supporting a reportable finding are included in the examination file.

Priority: Medium.

MFDA's response:

MFDA staff agrees that all documentation supporting reportable findings should be included and retained in the examination working paper file. The item identified by OSC staff was an inadvertent and isolated error. It is MFDA staff's view that the existing processes, which include: a detailed examination program; initial and ongoing training for examination staff; a second level manager review of financial compliance staff's work; and a section in the Financial Examiner Reference Manual containing "Field review documentation standards", are sound internal control practices to ensure working papers are complete and issues supported. That being said, MFDA staff will be reminded of the importance of ensuring all issues are adequately supported in the working paper file and that they should review the minimum documentation standards outlined in the Manual.

Staff comments and follow-up:

MFDA's response is adequate.

(ii) Quality of work performed

Staff findings

OSC staff's review of financial compliance examination files indicated that the work performed by MFDA staff was generally thorough and of high quality. However, OSC staff noted that, for three files reviewed where the members failed to report certain accounts such as trust and operating bank error or

suspense accounts in the FQRs, the FCEs correctly identified and reported the members' failure to include these accounts in the FQR, but did not comment on the impact of this omission on the members' RAC; on the adequacy of the members' processes to reconcile accounts; on whether the existence of these suspense accounts indicated operational concerns at the firm; or on whether these accounts were properly set up in the members' general ledger. As completeness of accounting books and records is key in producing accurate capital and management reports, OSC staff are concerned the exclusion of certain accounts, and particularly suspense trust and bank accounts in a member's FQR, may indicate weaknesses in the member's operations and may result in inaccurate reporting of the member's capital and financial positions.

OSC staff's independent field review of a member that had intercompany accounts showed that the FCE noted that the member misclassified an intercompany balance. The FCE correctly instructed the member to report the balance on Line 16 of Statement A, but did not comment on the improper maintenance of related party transactions on the member's books and records. Related party transactions and advances were not booked properly into an appropriate 'due to or from related party' general ledger account, but were comingled with general receivables and payable accounts of the member. OSC staff also reviewed the related parties service agreements and found that it allows funds to be transferred between related parties with no repayment terms. Given that advances from members to their affiliated entities could result in an outflow of financial resources from members to non-members, OSC staff are of the view that it is important to carefully review the terms and amount of such advances in order to ensure that they are reasonable, and that the purpose and validity of intercompany transactions should also be reviewed.

Staff recommendations

When a member fails to include certain accounts in the FQR, the MFDA should also consider and comment on the impact of such omissions on the member's RAC or earnings, and on the overall completeness of the member's books and records. For members with suspense or error accounts, the MFDA should also assess whether there is an indication of operational concerns at the firm.

Priority: High.

MFDA's response:

MFDA staff agrees that it is a serious deficiency when a Member fails to completely report all accounts, such as trust accounts and error or suspense accounts, on its financial report. Generally, the most serious financial compliance deficiencies identified will be presented at the beginning of the final examination report issued to the Member. This type of deficiency is therefore generally presented as one of the first issues within the examination report. Going forward, the issue will be presented with the impact on RAC noted in parenthesis on the report. In such cases, where MFDA staff is not in a

position to quantify the impact of the deficiency on RAC, this too will be raised in the examination report stating the impact is “indeterminable”.

The examination program currently has steps requiring MFDA staff to document the “purpose, processes and activities” relating to error and suspense accounts. An additional step will be added to the program requiring MFDA staff to “assess and conclude” whether the use and/or existence of these accounts indicate there any operational concerns with the Member.

Staff comments and follow-up:

MFDA’s response is adequate. We ask that the MFDA provide OSC staff with a revised copy of the examination program by September 30, 2010.

With respect to intercompany account balances, the MFDA should, in addition to reporting errors in financial statement presentation, also determine whether intercompany amounts are properly separated from the members’ other receivable or payable accounts; assess the reasonableness of the repayment terms in the service agreements between the related parties; and assess the business purpose of the transactions in order to ensure that they relate to legitimate transactions.

Priority: High.

MFDA’s response:

MFDA staff agrees that intercompany balances should be reported separately from the Members’ other receivable or payable accounts. Consequently, a separate step in the examination program will be added to specifically require MFDA staff to test that separate disclosure is provided for intercompany balances.

The examination program currently includes steps to obtain and review related party agreements and determine whether the transactions outlined in the agreement are properly recorded on the FQR. In addition, the program requires MFDA staff to review intercompany reconciliations and review for unusual transactions.

MFDA will, however, provide additional guidance to Members and training for staff with respect to the level of specificity necessary in management or services agreements in order to properly assess the financial condition of a Member who is a party to a management or cost-sharing agreement.

Staff comments and follow-up:

MFDA’s response is adequate. We ask that the MFDA provide OSC staff with a copy of the examination program, revised with the additional step related to intercompany accounts, by September 30, 2010.

(iii) Financial compliance in Alberta

Staff findings

ASC staff's review of financial compliance files revealed that Financial Compliance staff thoroughly complete the MFDA's planning stages prior to each financial examination.

In preparation for its annual examination, Financial Compliance staff complete a detailed planning memo that describes the operations of the member to be examined and identifies perceived risks.

It appears Financial Compliance is able to encourage the members to correct its deficiencies and comply with regulatory requirements in a responsive and timely manner.

Overall, the financial examination process is comprehensive and appears to be successful in achieving its objectives. In addition, Financial Compliance appears to be responsive to issues of investor protection when members demonstrate financial risk in the marketplace. Financial Compliance is able to take immediate action and place restrictions on a member's activities to mitigate existing or potential risks.

Staff recommendations

None.

6. Communication with Policy and Enforcement departments

Background information

OSC staff discussed the communication processes between Compliance, Enforcement and Policy departments with MFDA management. In addition, OSC staff reviewed internal reference manuals, and policies and procedures regarding referrals to Enforcement, including the *Compliance and Enforcement Referrals and Information Sharing Policies*. These policies specify the circumstances under which the Compliance Department is to refer files to Enforcement. Such circumstances include instances of significant repeat deficiencies and serious compliance weaknesses.

Compliance and Enforcement managers meet every two weeks to discuss the status of any files referred to Enforcement by Compliance. In addition, the managers discuss 'grey areas/issues' that arise, to determine whether the issue could become an enforcement matter.

Generally, any matter relating to a member's non-compliance with, or breach of, MFDA Rule 3 *Financial and Operations Requirements* and Rule 4 *Insurance*, which cannot be resolved by Financial Compliance staff's imposing of additional restrictions, may be referred to Enforcement. Members' failure to obtain approval from the MFDA before completing transactions such as, repayment of subordinated

loans, changes in capital structure or equity interest of the firm, mergers or reorganizations, and increases in capital structure or equity interest of the firm, may also be referred to Enforcement.

The VP of Compliance meets with the Director of Policy on a regular basis to discuss policy matters relating to both sales and/or financial compliance. If there is an identified need to amend or enhance Rules relating to the financial requirements of members, Financial Compliance staff may participate in the preliminary drafting of a rule, which is then forwarded to the VP of Compliance and Director of Policy for further review.

Staff findings

The MFDA's process for communicating with Policy and Enforcement departments appears adequate.

Staff recommendations

None.

F. Membership

1. Introduction

OSC Rule 31-506 requires mutual fund dealers to be members of the MFDA. The MFDA is required by T&C #6 of the RO to accept all properly registered mutual fund dealers into membership, provided that they meet the membership criteria. MFDA's By-law No. 1 sets out the criteria for eligibility into membership, the MFDA's process for review for membership applications, and the materials that must be submitted by the applicants.

Staff of the MFDA's Communications and Membership Services Department (Membership Services) are responsible for coordinating the application review process and act as the liaison between the MFDA and applicants for membership. The department is comprised of the Director of Membership Services, the Membership Services Coordinator, a communications officer, and an administrative assistant.

2. Purpose and scope

The purpose of this section was to determine whether the MFDA has fair and consistent processes for reviewing and approving membership applications and requests for members resignations and reorganizations; and whether it complies with the applicable provisions of MFDA's By-law No. 1.

To meet these objectives, OSC staff reviewed relevant sections of the MFDA's By-law No. 1, various internal policies and procedures documents as well as checklists and programs used by MFDA staff to review applications, and a sample of files related to new membership applications and requests for resignations and reorganization.

3. Policies and procedures

Background information

OSC staff reviewed policies, procedures and other templates that set out the steps taken by the MFDA's Membership Services when reviewing applications for membership. OSC staff also reviewed the *Compliance Officer Reference Manual* that includes the procedures followed by Compliance staff involved in the review of new membership applications, and requests for approval of resignations and reorganizations. OSC staff discussed with MFDA management the processes, including changes that occurred during the Review Period, for new membership applications, and requests for approval of resignations and reorganizations.

Staff findings

The policies and procedures for processing membership applications and requests for approval of resignations and reorganizations are comprehensive. They provide adequate guidance to MFDA staff involved in the review. In addition, the checklists and programs used by the MFDA departments involved in the process are detailed and provide adequate guidance to MFDA staff. There have been no significant changes to these programs during the Review Period.

Staff recommendations

None.

4. Benchmarks

Background information

OSC staff reviewed the MFDA's benchmarks for new member application reviews and discussed timelines for review of membership applications with management.

The existing benchmarks are as follows:

- Membership Services generally sends a letter acknowledging receipt of membership applications or requests for approval of resignations or reorganization within two business days of receiving the application.
- the Membership Coordinator completes a preliminary review of the application, to determine completeness of the materials provided by the applicant, within three business days of being assigned the file.
- if deficiencies in the membership application are noted, the applicant is sent a letter outlining such deficiencies and is given seven business days to respond.

There are no formal benchmarks for overall completion of the application review, since the MFDA has to rely on the applicants for the timely provision of materials. However, the goal is to complete review of membership applications within six months from their receipt.

In addition, if membership is granted subject to T&Cs, the MFDA has a number of internal timelines to monitor its members' compliance with the T&Cs, and follow-up on outstanding materials.

Staff findings

The existing performance benchmarks and timelines for membership application and requests for resignation and reorganization reviews are adequate for general monitoring purposes.

Staff recommendations

None.

5. Review of membership application files

Background information

OSC staff reviewed a sample of 4 out of 10 applications for membership received during the Review Period. The files included the Application Form Review Program completed by the MFDA's Sales and Financial Compliance staff.

Staff findings

OSC staff's review of the sampled files shows that, overall, the work performed by MFDA staff was adequate and properly documented. The conclusions in the working paper files were appropriate and properly supported by the documentation in the files. The MFDA's internal benchmarks were met and, overall, applications were completed on

a timely basis. There was evidence of frequent follow-up and other correspondence between MFDA staff and the applicants.

Staff recommendations

None.

6. Review of member reorganization files

Background information

Section 13.7 of MFDA's By-law No. 1 requires that MFDA dealers notify the MFDA, in writing, no less than 30 days prior to a reorganization, merger or amalgamation, change in control or other such combinations (collectively, reorganizations). It also requires dealers to obtain MFDA approval for reorganizations.

OSC staff reviewed a sample of four files related to requests for approval of reorganization from a total of 44 applications received during the Review Period. The files included the MFDA's Financial Compliance group's working paper files.

Staff findings

The sampled files were well documented and, based on OSC staff's review of the documentation, the MFDA's review was thorough. T&Cs, where imposed, were adequate.

Staff recommendations

None.

7. Review of member resignation files

Background information

Section 13.1 of MFDA's By-law No. 1 requires MFDA dealers wishing to resign to address a letter of resignation to the MFDA's board. Section 13.2 of By-law No. 1 requires that members wishing to resign set out the reasons for resigning. Section 13.2 also sets out the materials that members must submit.

OSC staff reviewed a sample of 2, out of 21 applications for resignation received during the Review Period.

Staff findings

The sampled files were well documented. The MFDA's Financial Compliance group's working paper files showed that the MFDA requested and received the materials set out in section 13.2 of By-law No. 1. In addition, the MFDA obtained confirmation that the resigning members' client accounts were properly transferred to other dealers, before the resignation became effective. Bulletins to announce the members' intention to resign and the effective dates of resignation were issued on a timely basis.

Staff recommendations

None.

G. Business Continuity Plan

1. Introduction

Under the MFDA's conditions of recognition, T&C #12 requires the MFDA to have adequate arrangements and resources for the effective monitoring and enforcement of compliance with its rules. In addition, the MFDA is required to respond promptly and effectively to public inquires, have effective arrangements for the investigation of complaints against its members or their APs, and ensure it is accessible to the public. A business continuity plan ensures that critical operations continue to be available during a business interruption and is a guide to recover a company's operational state following such an interruption. These plans typically reflect a worst-case disaster scenario to avoid reacting impulsively at a time when priorities and focus need to be on the tasks required.

The MFDA engaged outside expertise to assess the MFDA's BCP needs and design the appropriate plan. The organization completed this work and coordinated an initial BCP test for the MFDA.

2. Purpose and scope

BCSC staff assessed the adequacy of the BCP with respect to existing threats, current industry practices, and corporate governance requirements. BCSC staff also evaluated the effectiveness of the controls in place to practically facilitate a recovery of the MFDA's critical and routine business functions after a major or minor interruption, while maintaining appropriate service levels with its stakeholders. Finally, BCSC staff assessed the sufficiency of the DRP and ensured it was synchronized with the MFDA's BCP.

To make these assessments, BCSC staff reviewed the MFDA's BCP and DRP, the test reports of independent consultants, various internal policies and procedures, and key staff's awareness of these plans. BCSC staff interviewed the Manager of Information Technology (IT).

3. Background considerations of BCP

Background information

BCSC staff read the MFDA's BCP and DRP, visited the MFDA's emergency recovery facility, and interviewed the Manager of IT. BCSC staff also reviewed various materials to understand the considerations behind the construction of the MFDA's BCP, and to assess their adequacy.

Staff findings

The BCP contains adequate details confirming that the MFDA considered appropriate factors during the plan's development. Considerations underlying its development include assigning ownership of the plan to the Manager of IT, completing a business impact analysis to identify critical applications and services, and establish appropriate recovery times, establishing risk management procedures to address identified risks; involving key business users (such as Accounting, Corporate Secretary and Financial

Compliance) in its design, and communicating clearly the objectives and recovery strategies to be used.

Specifically, the BCP includes clear instructions for local Incident Response Teams as well as a Crisis Management Team (CMT) responsible for running the business in disaster mode. While decision criteria for declaring an emergency or a disaster are not specifically stated, the CMT has planned guidelines for recovery, thereby allowing them to make such a declaration based on the actual situation and their expert knowledge of business requirements. The CMT plan that is included as part of the overall BCP contains an adequate level of tasks to accommodate assembly, communication, and coordination to ensure the above will occur within acceptable timeframes.

Daily operational procedures for timely data backup and retrieval are in place in IT and through contract with a primary Canadian data storage and information recovery facility. The MFDA's BCP includes instructions to ensure staff are afforded secured offsite access to the MFDA's systems and, critical resources and services are available once a crisis is declared. When IT services are not yet available, the plans contain interim instructions for manually carrying out important tasks. The BCP appropriately identifies critical procedures and processes to support core business functions, reasonably considers the interdependencies between functions, and properly coordinates them in its recovery strategy.

Overall, BCSC staff are satisfied that the background considerations for the MFDA's BCP were comprehensive and adequate.

Staff recommendations

None.

4. Staffing arrangements and BCP contents

Background information

BCSC staff reviewed the contents of the BCP to ensure the plan takes into account the user's needs under crisis conditions and that the BCP appropriately reflects the MFDA's corporate culture, its infrastructure and the type of service it provides to its stakeholders.

Staff findings

Generally, the BCP adequately takes into account the users' needs under crisis conditions and it adequately reflects the MFDA's corporate culture, infrastructure, and type of service provided to its stakeholders.

Specifically, the plan includes a complete and detailed overview of pre-emergency instructions and post disruption procedures, including staff debriefing meetings. The biannual evacuation drills enable staff preparedness in the event of a disruptive incident.

The MFDA uses two disaster recovery sites administered by two reputable enterprises. In each case, arrangements are in place to accommodate MFDA staff for both tests and live disruptions, if necessary. In addition, one facility offers alternative sites to accommodate

the MFDA's BCP if it reached capacity at time of disaster. This minimizes the risk of not having a recovery facility when needed.

The MFDA's Head Office makes all disaster declarations; its BCP includes communication and establishment of network access from authorized and secured offsite locations for MFDA staff, including those from its Pacific and Prairie regional operations. It guides staff to work from these offsite locations.

The MFDA utilizes a unique and efficient method for testing its ability to restore services in a disaster situation. At the time of the interviews, the MFDA tested its CMT's ability to run the business from the MFDA's recovery facility. The test report listed seven items that required attention, but considered these as minor anomalies. Functional testing involving critical groups, as well as a full-scale test are still to be scheduled.

Also, the MFDA's BCP does not have formalized procedures for dealing with additional expenditures that could arise during a disruption. However, BCSC staff are satisfied that the MFDA's approval process, established credit lines, and availability of the CMT are sufficient to deal with such spending decisions during this time.

Overall, BCSC staff are satisfied that the MFDA's BCP contains adequate steps, and utilizes appropriate recovery sites and procedures that would enable the MFDA to promptly recover during a minor or major business interruption, while maintaining appropriate service levels with its stakeholders. Further, the DRP was reasonably synchronized with the MFDA's BCP.

At the time of the review, the MFDA had just completed scripting an internal communication informing staff of its contact procedure for keeping staff informed during a crisis; however, the MFDA had yet to incorporate this procedure into the BCP. Also, BCSC staff noted that the MFDA's BCP allocates various business and technical functions to specific individuals by name, instead of by generic staff positions and required skill set. As such, the MFDA must update the BCP each time there are staff changes involving any of the named individuals. Finally, in a significant disaster that affects the availability of key staff, the plan lacks a step ensuring the responsibilities of any unavailable staff are appropriately reassigned.

Staff recommendations

The MFDA should incorporate into its BCP its contact procedure for keeping staff informed during a crisis.

The MFDA should also revise its BCP by replacing named individuals with staff positions and required skill set for each specified business and technical function.

Finally, the MFDA should amend its BCP to include a step ensuring the responsibilities of any unavailable staff are appropriately reassigned to available staff.

Priority: Low.

MFDA's response:

The MFDA will incorporate its contact procedure for keeping staff informed during a crisis into the BCP.

The MFDA will replace named individuals with staff positions. Since all MFDA positions have a corresponding job description that is kept current, reference will be made to each position's corresponding job description that elaborates upon the skills required for the position.

The BCP outlines critical functions to be performed throughout various durations of outages. Staff is, therefore, aware of activities to be performed and will reassign duties to available staff accordingly. The MFDA will adjust the wording in the BCP to ensure that this task is made clear.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response. We ask that the MFDA provide BCSC staff with the revised BCP by September 30, 2010.

5. BCP maintenance

Background information

BCSC staff reviewed the MFDA's business methods and procedures to understand how the MFDA maintains an updated BCP, and to assess whether its maintenance procedures are adequate.

Staff findings

The MFDA has a schedule of planned tests that includes a full-scale disaster recovery test. Thereafter, departments will decide whether restoration testing is required. User acceptance testing is ongoing via the technical recovery approach that utilizes their development and user acceptance testing server facility.

The MFDA updates its BCP at least annually. The plan names the current Director of Finance and Administration as being responsible for this task. The MFDA follows a change management methodology for its applications to ensure BCP updates are considered.

The MFDA has established schedules for carrying out incremental and full data backup, with regular pickup and delivery of these backup tapes to its offsite storage location. Emergency retrieval procedures are also in place to ensure timely retrieval of these tapes from storage.

Managers ensure their staff are aware of the BCP through discussions at departmental meetings. Also, the BCP is addressed in all new applications, services, and hardware install implementation plans. As a result, the MFDA's communication and focus on BCP is well in hand.

The current BCP is paper-based with a plan for conversion to an electronic format in the near future. At this time, the recovery of paper records have not been considered as part of the business BCP. The MFDA is planning a records management project, where a defining schema for that initiative is underway. Completion of this records management initiative will also allow for the recovery of current paper based documents in electronic format.

BCSC staff are generally satisfied with the MFDA's current BCP maintenance procedures and the MFDA's plan to enhance these procedures; however, BCSC staff have suggestions for consideration.

Staff recommendations

BCSC staff recommend that the MFDA ensure its records management initiative considers inclusion of critical documents in its BCP. For future consideration, BCSC staff also recommend that the MFDA include annual BCP testing as an ongoing MFDA initiative after the first full scale test is completed.

Priority: Low.

MFDA's response:

The MFDA's records management project will take into account all critical documents regarding the BCP. Since the CSA Oversight Review, the MFDA's BCP was tested in July of 2009. The MFDA has also scheduled ongoing annual testing of the BCP, with the next test scheduled for July/August 2010.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response. BCSC staff will follow-up on this matter at its quarterly oversight meeting with the MFDA.

H. Cooperative Agreement

1. Introduction

T&C #12 (A) and (B) of the BCSC RO require the MFDA to obtain Commission consent to arrange with another party to monitor and enforce compliance with its Rules, and to investigate complaints against its members and their APs.

In Québec, the MFDA is not recognized or approved as an SRO, so it cannot directly regulate the activities of these MFDA members and their APs. For this reason, the MFDA signed an agreement to cooperate with the provincial regulators of Québec, the AMF and the Chambre. For MFDA members and APs that operate inside and outside Québec, the Agreement of December 2004 would ensure public protection while avoiding regulatory duplication. The Agreement addresses how the regulators coordinate their sales and financial compliance examinations, complaint handling and investigations, and policy development, and share information in order to effectively regulate this group of mutual fund dealers and their APs.

The MFDA represented in its consent application that it performed similar regulatory activities, and had substantially similar rules and regulations, and the similar regulatory objectives as those of the AMF and the Chambre. Since the MFDA IPC currently does not cover customer accounts in Québec at MFDA members, it is not imperative, from the perspective of the MFDA IPC, that the MFDA effectively monitor the financial position of its members operating in Québec.

The RRs consented to the Agreement, with the BCSC issuing and then replacing its consent order on May 20, 2005 and June 5, 2008, respectively. As conditions of consent, the RRs require the MFDA to regulate its members on the basis that its members will, by complying with the *Securities Act* (Québec) and its regulations relating to business conduct and sales practices in Québec, be deemed to be complying with the MFDA's rules relating to the same subject matter. In addition, the conditions required the MFDA, in coordination with Québec's provincial securities regulators, to meet effectively all of its obligations regarding the regulation of its members under the Agreement.

2. Purpose and scope

BCSC staff assessed whether the MFDA's regulation of its Québec members for compliance with prudential, and business conduct and sales practice rules is consistent with its regulation of its non-Québec members. BCSC staff also evaluated the adequacy of the MFDA's complaint referral process for referring complaints to the AMF and the Chambre, and whether the MFDA has adequate processes in place to ensure continued harmonization of its rules and regulations with those of the AMF and the Chambre. Finally, BCSC staff reviewed the adequacy of the MFDA's process for sharing information with the AMF and the Chambre regarding business, operations and activities of its Québec members and APs.

To make these determinations, BCSC staff reviewed the Agreement and various internal policies and procedures. BCSC staff also interviewed senior management from various MFDA departments, and sought feedback from relevant AMF staff as coordinated by the Director of Distribution Practices (Directeur des pratiques de distribution) at the AMF. Lastly, BCSC staff reviewed a sample of complaint, case assessment, investigation, sales compliance, and financial compliance files.

3. Prudential regulation of MFDA members in Québec

(a) Prudential examinations

Background information

BCSC staff interviewed MFDA and AMF staff to understand how mutual fund dealers headquartered in Québec are regulated regarding prudential matters. AMF staff also shared their experiences coordinating with the MFDA in this regard. BCSC staff also reviewed a randomly selected MFDA financial examination file of a Québec member, all early warning notifications during the Review Period, and MFDA's performance statistics for Financial Compliance.

MFDA management informed BCSC staff that in 2005, MFDA and AMF staff jointly conducted these examinations (together with the sales compliance examinations until 2006). Typically, the MFDA would provide the AMF with one-month advance notice. If either wanted to go in earlier, they were able to accommodate each other. The AMF and the MFDA each had separate examination programs to ensure compliance with their respective prudential rules. AMF staff attributed the different programs to the MFDA's rules being more explicit and detailed in nature, and the financial requirements being more stringent. Although the two financial compliance examination teams coordinated their visits and conducted their exit meetings together, each team produced their own examination report. The MFDA shared their report with the AMF.

In the next two years, the AMF gradually increased its reliance on the MFDA to conduct financial compliance examinations using the MFDA's program. However, AMF staff continued to attend the exit meetings. In 2008, the MFDA began providing the AMF with an annual financial compliance examination schedule. The AMF fully relied on the MFDA to conduct these examinations, but AMF staff continued to attend the exit meetings and received the final report.

Similar to other jurisdictions, the MFDA notified the AMF when a Québec member triggered early warning and when the warning has been removed.

Staff findings

Overall, BCSC staff found evidence of reasonable coordination and communication between the MFDA and the AMF. The MFDA has the same examination process and uses the same financial compliance examination program regardless of where the MFDA member is headquartered.

BCSC staff also found that the performance of these examinations is consistent with other financial compliance examinations conducted by the MFDA's head office Financial Compliance team in terms of the process followed, the quality of the examination files produced, and the timeliness of examinations completed.

AMF staff informed BCSC staff that they were satisfied with the timeliness and quality of the MFDA's financial compliance examinations because they were not aware of any financial-related problems in Québec that went undetected by the MFDA for the Review Period. They also appreciated the MFDA's willingness to explain the deficiencies found and to provide documentary support when requested.

Staff recommendations

None.

(b) Enforcement actions related to prudential matters

Background information

BCSC staff interviewed MFDA management and reviewed the list of financial compliance referrals to the Enforcement Department.

MFDA management informed BCSC staff that the MFDA uses the same referral criteria for referring financial compliance matters to Enforcement regardless of where the member is headquartered.

MFDA management also indicated that the Enforcement Department treats cases of Québec and non-Québec members in the same way. They go through the same assessment, investigation, and litigation process. The MFDA's case tracking system is capable of tracking these referred cases. The MFDA reports these cases to the AMF through its monthly reports of Québec enforcement cases, the same reporting process as with other CSA jurisdictions.

Staff findings

During the Review Period, there were no referrals to Enforcement of prudential matters related to Québec members. BCSC staff are confident that the MFDA uses the same process for referring financial compliance matters for Québec and non-Québec members. BCSC staff are also satisfied that this coordination with the AMF does not materially impede the time required to issue these examination reports as the performance statistics for Québec examinations do not materially deviate from the MFDA's national performance statistics.

Staff recommendations

None.

4. Business conduct and sales practice regulation

Background information

BCSC staff interviewed MFDA and AMF staff to understand how mutual fund dealers headquartered in Québec are regulated for business conduct and sales practice. AMF staff

also shared their experiences coordinating with the MFDA in this regard. BCSC staff also reviewed a randomly selected MFDA compliance examination file of a Québec member and MFDA's performance statistics for Compliance.

MFDA management informed BCSC staff that they would usually conduct joint examinations with the AMF of Québec members with non-Québec branch operations. The same examination procedures apply as with other MFDA members. The only difference is the additional coordination with the AMF on these examinations.

In December of each year, the MFDA provides the AMF with its annual sales compliance examination schedule for the coming year. When possible, the MFDA and the AMF will coordinate their sales compliance examination of a Québec member's head office. The AMF issues a letter notifying the mutual fund dealer of the upcoming joint examination. MFDA and AMF review teams will conduct their own examinations according to their respective compliance examination programs. During the fieldwork, MFDA and AMF staff will alert each other of potential concerns that may extend into the other's jurisdiction. To minimize the disruption on the member, the two teams will conduct joint interviews when appropriate. As with non-Québec members, the MFDA will also coordinate its own review of branches outside of Québec. Upon completion of the examination, the MFDA and AMF teams will jointly conduct their exit meeting with the member. They also will try to issue their respective reports jointly, when possible.

Staff findings

Generally, BCSC staff found evidence of good coordination and communication between the MFDA, the AMF and the Chambre, when applicable. The MFDA has the same sales compliance examination process and uses the same examination program regardless of where the MFDA member is headquartered. AMF staff confirmed that there are no significant differences in substantive examination procedures between the AMF's and the MFDA's examination program, although there are significant procedural differences at the planning stage. The AMF's planning procedures results in more pre-fieldwork gathering of information from the member, and selecting of various samples before the onsite visit.

Although the member has two teams to contend with concurrently, AMF and MFDA staff examine different client populations, but keep each other apprised of concerns noted, including those that may deserve a closer examination by the other team. BCSC staff also found that the performance of these joint examinations is consistent with other compliance examinations completed by the MFDA's head office Compliance team in terms of the process followed, the quality of the examination files produced, and the achievement of their performance benchmarks.

At the end of the examination, the MFDA provides a copy of its final report to the AMF. AMF staff described their experience with MFDA staff as positive overall and credit them with helping develop some of the AMF's current approaches used to examine mutual fund dealers.

BCSC staff are satisfied with the coordination between the MFDA and the AMF on sales compliance examinations, and are confident that the MFDA is regulating the business conduct and sales practices of Québec members in the same manner as those of non-Québec members. BCSC staff are also satisfied that this coordination with the AMF does not materially impede the time required to issue these examination reports as the performance statistics for Québec examinations do not materially deviate from the MFDA's national performance statistics.

Staff recommendations

None.

5. Complaints handling and sharing of general information

Background information

BCSC staff interviewed MFDA and AMF staff to understand how the MFDA ensures that it refers complaints to the AMF and the Chambre, as appropriate, periodically reports to the AMF on the status and conclusion of complaints referred from them, and shares general complaint-related information with the AMF and the Chambre. BCSC staff also examined evidence of such communication and cooperation, and solicited feedback from AMF staff in this regard.

For the Review Period, BCSC staff selected a sample of 22 Québec-related public inquiries from the MFDA's call log, six Québec-related public complaints received by the MFDA's intake staff, and nine enforcement files. BCSC staff reviewed the MFDA's online records to ensure bona fide referrals to the AMF were not missed and to ensure there was reasonable coordination and cooperation with the AMF and the Chambre, when appropriate.

Staff findings

In the sample reviewed, BCSC staff were unable to find any missed referrals to the AMF or the Chambre. When appropriate, BCSC staff found evidence of good communication and sharing of information with the AMF and the Chambre. BCSC staff also noted that the MFDA's assessment and investigation procedures for Québec cases were the same as for non-Québec cases, and that Québec cases met the enforcement benchmarks.

AMF staff confirmed that they had not referred any complaint files to the MFDA during the Review Period. However, AMF staff indicated that the MFDA had referred two complaint files to them. The AMF's investigations unit was satisfied with the quality of the files referred to them by the MFDA and with the level of communication and sharing of enforcement-related information received from the MFDA.

Staff recommendations

None.

6. Policy development

Background information

BCSC staff interviewed MFDA and AMF staff to understand how the MFDA ensures continued harmonization of its Rules and regulations with those of the AMF, and communicates and cooperates with the AMF on rule development and amendments, and notices, directions and other such communications. BCSC staff also examined evidence of such communication and cooperation, and solicited feedback from AMF staff in this regard.

MFDA management informed BCSC staff that AMF regulations for mutual fund dealers and mutual funds are generally less detailed than those of the MFDA. Frequently, the AMF may not have equivalent rules or policies to those of the MFDA and as such, the AMF would at times refer to specific MFDA rules when communicating with member firms.

To ensure continued harmonization of rules and regulations with the AMF, the Policy Department monitors policy developments in Québec (and other jurisdictions) that are applicable to mutual fund dealers, and communicates internally to staff through weekly summaries. AMF staff regularly attend the MFDA's Member Regulation Forums held in Montreal, where MFDA staff provide an update on current and upcoming policy initiatives. Recent national policy initiatives include registration requirements (National Instrument 31-103), the client relationship model, and complaint handling requirements. Both the MFDA and the AMF are members of the National Instrument 31-103 working group, where they have shared information on these three initiatives. MFDA and AMF staff will also share or discuss policy-related matters in a less formal setting, such as informal meetings, telephone calls, and by email.

For member regulation notices, the MFDA provides relevant material notices to the AMF prior to issuing these notices, to allow the AMF time to coordinate, if necessary. When appropriate, AMF staff share with MFDA staff, important research information, that would help with the crafting of the notices.

Staff findings

BCSC staff found evidence of the coordination and communication between AMF and MFDA staff. BCSC staff saw MFDA weekly summaries of regulatory policy documents issued by the AMF, presentation materials of several MFDA Member Regulation Forums held in Montreal, and various correspondences between the MFDA and the AMF showing discussions on policy-related matters and advance notice of relevant member regulation notices.

BCSC staff are satisfied with the MFDA's processes to ensure continued harmonization of rules and regulations in Québec, and appropriate coordination and communication on policy-related matters with AMF staff.

AMF staff informed BCSC staff that the AMF's existing coordination with the MFDA was meeting current needs.

Staff recommendations

None.

III. Pacific Regional Office

A. Summary

1. Background

During January and February of 2009, BCSC staff conducted a review of the MFDA's PaRO. BCSC staff focused this review on regulatory activities carried out by this office during the Review Period. BCSC staff reviewed Enforcement (specifically Investigations), Compliance and Membership.

2. Assessment of findings

The PaRO established and implemented adequate processes, policies and procedures for Investigations, Compliance and Membership. The files were generally complete and well organized. The work in the files were of good quality. For the Review Period, the PaRO had adequate resources and consistently met its benchmarks. Overall, the PaRO sufficiently met its regulatory responsibilities and achieved its public interest objectives for the Pacific region. However, BCSC staff have some recommendations that identify areas for improvement in Investigations and Compliance. The MFDA should take remedial action to address these concerns.

B. Enforcement

1. Introduction

Under the MFDA's conditions of recognition, T&C #7(A), the BCSC requires the MFDA to enforce compliance by its members and their APs with MFDA regulatory requirements and the applicable securities legislation. In addition, under T&C #8, the MFDA can subject its members and their APs to its review, enforcement and disciplinary processes.

2. Purpose and scope

BCSC staff assessed whether the MFDA's enforcement decisions and actions for the Pacific region were fair, consistent, reasonable, and timely; and complied with T&C #7 and 8 of the RO, and the applicable provisions of MFDA By-law No. 1. BCSC staff also evaluated whether the MFDA's enforcement process achieved the desired outcome of protecting the investor and deterring future transgressions in the Pacific region.

To make these assessments, BCSC staff reviewed the structure, staffing, and resources of the Enforcement Department, the relevant provisions of the MFDA's By-law No. 1, related rules, and various internal policies and procedures. BCSC staff also interviewed the MFDA's Enforcement staff and examined how the department communicates internally (intra- and inter-departmentally) and externally. Finally, BCSC staff reviewed departmental statistics, case completion data, and a sample of case assessment, investigation and litigation files, and file outcomes.

Because the MFDA's Case Assessment and Litigation groups are located at head office, II.D.6 and II.D.8, respectively, detail BCSC staff's findings and recommendations for Pacific regional matters.

3. Department structure – reporting structure and management oversight

Background information

In addition to interviewing Enforcement staff, BCSC staff reviewed the Enforcement Department's organizational chart and various job descriptions to understand the reporting structure and the changes since the last oversight review.

All Case Assessment and Litigation staff are located in Toronto, whereas investigators for the Pacific region and the Manager of Investigations, Pacific and Prairie Regions, are located at the PaRO.

The Investigations group is led by the Director of Investigations (at head office) who was hired since the last oversight review. The MFDA also created three new manager positions, two at the Toronto Head Office to report directly to the Director of Investigations and one for the Pacific and Prairie regional offices, to report to the two regional directors and the Director of Investigations. The Manager of Investigations, Pacific and Prairie Regions, oversees one investigator in BC and two investigators in Alberta.

To ensure accountability, staff have regular meetings with their immediate report, with their group, and with the Enforcement Department. The Enforcement Department also has formalized managerial review and case escalation processes, and regular internal audits of staff's files. Regional directors participate in the case escalation processes involving the ERC and the Proceedings Authorization Committee. Managers monitor the progress of their staff's work with the BPM system, which replaced the Enforcement Tracking System for the Case Assessment group on June 30, 2008. The MFDA is currently implementing the BPM system for the Investigations and Litigation groups.

Staff findings

BCSC staff are satisfied that the Enforcement Department has an adequate reporting structure, review processes, and supervisory systems to ensure appropriate accountability, nationally and regionally.

Staff recommendations

None.

4. Staffing resources and training

Background information

Please refer to the background information at II.D.4 of the report for additional details of the MFDA's staffing resources and training.

MFDA management informed BCSC staff that training for new and existing investigators at the region have not changed significantly since the last oversight review. During the Review Period, the MFDA increased its investigative staffing levels at the PaRO in January 2006 when they hired a second investigator. In 2008, the MFDA promoted one of the investigators to Manager of Investigations for the Pacific and Prairie regions in July, and terminated one investigator in November. The Manager of Investigations regularly carries a small caseload of her own investigations, in addition to her managerial duties. Senior management believes that the staffing levels for Investigations in the PaRO are sufficient for the Review Period.

Staff findings

BCSC staff found that the PaRO was one investigator short of its full complement during the last two months of the Review Period. As a result, the Manager of Investigations in the PaRO took on the additional caseload temporarily, but the MFDA was prompt to fill the vacancy in January 2009.

Overall, BCSC staff are satisfied that the Investigations group has sufficient resources to handle its current caseload for the Pacific region. Enforcement management monitors staff's caseload closely to ensure a reasonable distribution of cases amongst staff, and to anticipate and promptly address possible resourcing concerns. From the BC cases sampled, BCSC staff found that, whenever the department was short-staffed, management promptly addressed the situation without adversely affecting the case outcomes.

The PaRO's investigators that deal with cases from the Pacific region appear to have the necessary qualifications and training to perform their duties. BCSC staff also found that Enforcement's training and orientation programs for investigators are comprehensive and have kept up with industry and regulatory developments.

Staff recommendations

None.

5. Benchmarks and sub-benchmarks

Background information

Please refer to the background information at II.D.5 of the report for details of the MFDA's benchmarks and sub-benchmarks.

Staff findings

BCSC staff found that the Investigations groups' benchmarks and sub-benchmarks are reasonable and appropriate, based on the complexity of the cases, the level of investigation expected, and staff's caseload. During the Review Period, the Investigations group consistently met its case completion benchmark both nationally and for the Pacific region.

Staff recommendations

None.

6. Investigations group

(a) Investigations processes and written procedures

Background information

BCSC staff interviewed Enforcement management at head office and at the PaRO to understand the procedures for Pacific regional cases handled by the Investigations group. BCSC staff also reviewed written policies and procedures, the *Case Screening Scorecard*, and various case-handling guidelines and procedural templates.

All cases go through the Case Assessment group at head office; however, Case Assessment immediately escalates some cases to Investigations. Once the ERC approves the escalation of a case to Investigations, the Director of Investigations assigns files based on the priority of the file, the investigator's workload and experience, and the region where the alleged transgression occurred. BC cases are assigned to PaRO investigators first. The investigator and their manager also discuss file prioritization and caseload at their bi-weekly meetings. Investigations utilize case screening scorecards for file prioritization and assignment. The scorecard is a risk assessment that assigns scores based on a variety of factors such as the nature of allegations, urgency, and impact on investors. The combined score identifies the level of priority for a file.

At the conclusion of an investigation, the investigator prepares an investigation report detailing their findings and recommendation. The Manager of Investigations, Pacific and Prairie regions, and the Director of Investigations review the report prior to file closure or escalation. The investigator, the Manager of Investigations, Pacific and Prairie regions, and the Director of Investigations jointly decide on the files to recommend for escalation to Litigation. The ERC reviews the file and, if appropriate, approves it for escalation to Litigation. The investigator closes those files not approved for escalation either without action or with an administrative resolution.

During the Review Period, the MFDA initiated the 25-file review pilot program for suitability cases. The purpose of the file review was to ascertain whether the alleged suitability concern was an isolated or a common incident. Under this program, the member reviewed 25 client files related to the AP for unsuitable investment recommendations. After running the program from 2005 to mid-2008, the MFDA determined that the cost-benefit from the 25-file review was not sufficient to warrant its continuation, as most BC cases related to the 25-file review exceeded the 365-day benchmark for closing files. Instead, the MFDA has implemented a process that focuses on a firm-wide review of member's policies and procedures and the 25-file review is only used on a case-by-case basis.

MFDA management informed BCSC staff that the MFDA updates its procedures and guidelines on an ongoing basis, and the various Enforcement groups discuss the procedures at their bi-weekly meetings. Also, MFDA staff have input in the drafting of all new procedures.

Staff findings

The investigation process is well structured and provides for regional accountability. The level of communication and cooperation between the PaRO and head office is adequate without being too burdensome. The extent of managerial and ERC involvement are appropriate to ensure a consistent approach at the PaRO, and the proper prioritization and escalation of cases to the Litigation group.

BCSC staff found that the MFDA's procedures and guidelines are generally comprehensive, clearly written and sufficiently detailed to provide adequate guidance to the Investigations group. However, BCSC staff found the procedures and guidelines were inadequate for file consolidation. From the sample of BC files, BCSC staff found different file documentation practices for cases that had multiple complainants and sub-files. Because some documents are retained in the main file and some in the various sub-files, this obscures the quality of the investigation performed.

Staff recommendations

BCSC staff recommends that the MFDA develop a more comprehensive procedure dealing with file consolidation, specifically dealing with file management and document management.

Priority: Medium.

MFDA's response:

We agree with this recommendation and are revising our current procedures to address the issue.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response. We ask that the MFDA provide BCSC staff with the revised procedures by September 30, 2010.

(b) Review of investigation files

Background information

BCSC staff examined a sample of 27 investigation files from the Pacific region. We assessed the files for quality of the work (including reasonableness of the investigation outcomes), timeliness of the investigation, and adequacy of the file documentation.

Staff findings

Overall, BCSC staff were satisfied that the investigators were diligent and the quality of their work was consistently good. Their investigation was objective and sound, and the case disposition or outcome was reasonable and supported by appropriate evidence on file. Investigators generally followed the procedures and guidelines in processing their cases.

BCSC staff found one case where the investigation appeared to be understaffed and one case where the MFDA did not make a timely referral to a CSA member. However, these appeared to be isolated instances.

Also, BCSC staff were satisfied that the Investigations group has completed its investigations of BC cases in a timely manner. In each fiscal year under review, BCSC staff found that the PaRO met its benchmark of closing or escalating 80% of its files within one year of opening the file in investigations. The majority of BC-related files that exceeded the 1-year benchmark were suitability cases where a 25-file review was the main cause of the delay. However, the MFDA has since implemented to a less resource intensive practice that focuses on a firm-wide review of the member's policies and procedures.

BCSC staff found that the sampled files were generally well documented and well organized. The investigators generally followed the file management and document management procedures. However, in the two instances of file consolidation, it appeared that the investigators did not follow standard file management and document management procedures. The instructions about file consolidation contained in the *Investigations Manual* do not provide clear guidance to investigators.

BCSC staff also found three cases where investigators did not provide written reasons for not including in the investigation report allegations that the investigator initially included in the investigation plan.

Staff recommendations

Please refer to recommendation at III.B.6(a).

C. Compliance

1. Introduction

T&C #7(A) of the BCSC RO requires the MFDA to enforce compliance by its members and APs with MFDA Rules and applicable securities or statutory legislation. To ensure compliance, T&C #7(B) requires the MFDA to conduct periodic reviews of its members and APs.

2. Purpose and scope

The primary objectives of this part of the review were to:

- review and evaluate the structure and resources, including staffing, of the PaRO's Compliance Department to ensure it performs its regulatory functions effectively and efficiently.
- evaluate the adequacy of the performance measurement benchmarks for compliance examinations and determine whether they were met.
- assess the adequacy, timeliness, and quality of compliance examinations.
- assess whether deficiencies reported during the first examination cycle were properly followed up and addressed by Compliance staff.

To fully understand and evaluate the MFDA's operations, BCSC staff:

- completed a review of various internal policies and procedures including training and orientation programs, staff guidance materials and referral processes.
- interviewed the VP of Compliance, Director of Sales Compliance, Director of Pacific Region, Compliance Manager for the Pacific region, and a CO.
- reviewed a sample of completed and open examination files to assess the quality of the reviews as well as the efficiency of the compliance examination process.

3. Department structure

Background information

The Compliance Department at the PaRO has one manager and five COs, including two senior COs. The PaRO's Compliance Manager reports directly to the Director of Pacific Region and indirectly to the Director of Sales Compliance at the MFDA's Toronto Head Office. The Director of Pacific Region reports directly to the Executive VP, and communicates and collaborates with the VP of Compliance and directors of Sales and Financial Compliance at head office.

The PaRO's Compliance staff are responsible for conducting onsite sales compliance examinations to review the compliance systems and procedures of head offices, branches, and sub-branches located in British Columbia (BC). By the end of the Review Period, fourteen MFDA members have head offices located in BC.

Staff findings

BCSC staff are satisfied with reporting structure at the PaRO and its management to staff ratio is adequate to ensure reasonable guidance is available to the PaRO's Compliance staff.

Staff recommendations

None.

4. Staffing resources and training

(a) Staffing resources

Background information

During the Review Period, staff levels increased with the addition of one new full-time CO. There was minimal turnover in the department with the promotion of the Compliance Manager to Director of Pacific Region and the resignation of one CO. The position of Compliance Manager was vacant for several months in 2007 following the promotion of the incumbent Compliance Manager to Director of Pacific Region.

Staff findings

While there were some staff movements during the Review Period, BCSC staff were satisfied that the staffing levels at the PaRO were adequate. Vacant positions were actively recruited and well managed to ensure the department operated at normal levels. Specifically, during the vacancy of the Compliance Manager in 2007, the Director of Pacific Region assumed the responsibilities of the Compliance Manager to ensure operations were not disrupted.

Staff recommendations

None.

(b) Training

Background information

The PaRO Compliance Department has maintained the same training and orientation process for new staff as identified in the previous review. This approach involves the new CO following a detailed checklist of administrative procedures, operations and training, MFDA systems, and review of the examination program and reference materials. New COs also participate in onsite training provided by experienced COs in the field.

The MFDA has continued its annual in-person training sessions, which bring together all COs from across the country. These sessions cover a variety of compliance related topics and help ensure a consistent approach amongst COs. Compliance staff also participate in lunch-and-learn training sessions throughout the year, which cover new industry trends, member rules, notices or policies, and internal policies and procedures.

Staff findings

BCSC staff reviewed the orientation checklist and materials for new COs. The checklist has been updated throughout the Review Period and includes new policies, systems, and reference materials. BCSC staff reviewed a sample of the annual in-

person training materials and the lunch-and-learn sessions and found them to be a good resource to staff. BCSC staff are satisfied with the orientation program as well as the ongoing training that is provided for Compliance staff.

Staff recommendations

None.

5. Benchmarks

Background information

Like the Enforcement Department, the MFDA's Compliance Department uses the BPM system to monitor the progress of examinations and the achievement of benchmarks. Every month, senior management reviews aging reports produced by the system and takes corrective actions, when appropriate. Compliance management in consultation with staff, consider ways to improve the examination program and process, to maximize investor protection value. At the end of each examination cycle, the MFDA reviews the appropriateness of its benchmarks, taking into account, but not limited to, planned changes to the examination program and process, past achievement of benchmarks, staffing and resources, and results of past examinations.

BCSC staff reviewed the PaRO's performance against its national compliance benchmarks as well as the MFDA's processes to monitor and revise those benchmarks. Please refer to the background information at II.E.4(b) for Compliance's national benchmark for issuing compliance examination reports.

Staff findings

According to the MFDA's internal statistics, the PaRO issued 17 final reports during the second review cycle. The PaRO issued 94% of their compliance examination reports within 15 weeks and all were within 22 weeks from substantial completion of fieldwork. On one occasion, the fieldwork end date did not coincide with the substantial completion of fieldwork date, as there was a four-week delay due to circumstances beyond the MFDA's control. Over 70% of the reports for BC members were issued between 12 and 15 weeks from substantial completion of fieldwork. Nationally, the MFDA achieved its benchmark with 92% of reports issued within 15 weeks and all reports were issued within 22 weeks from substantial completion of fieldwork. No report exceeded 20 weeks to issue.

BCSC staff acknowledge that the MFDA has revised their compliance benchmarks following each review cycle. Since the first review cycle, the MFDA has shortened its compliance benchmark from 26 to 20 weeks and increased the proportion of reports issued under the 15-week benchmark from 60% to 80%. However, BCSC staff also found that the MFDA's compliance benchmarks refer to the date of substantial completion of fieldwork, instead of the date of fieldwork completion that was noted in the previous oversight review. Substantial completion of fieldwork is defined in II.E.4(b).

BCSC staff are concerned that basing the benchmark on the current definition of substantial completion of fieldwork may not be a useful or accurate indicator of the time required to issue examination reports, particularly, under circumstances where member delays during fieldwork do not materially impede the progress of the overall examination process.

The MFDA's processes for monitoring the achievement of benchmarks, and conducting regular evaluations and revisions of its benchmarks are reasonable.

Staff recommendations

The MFDA should enhance the definition of its compliance benchmarks to clearly articulate the appropriate circumstances for using the substantial completion of fieldwork as the measurement start date for preparing and issuing examination reports.

Priority: Medium.

MFDA's response:

It is only in limited circumstances where there is: (i) management approval; and (ii) a significant delay in receiving key documents from the Member, that the fieldwork completion date can be extended beyond the date MFDA staff leaves the Member's premises. We adopted this approach because there are situations where staff is not provided sufficient information to complete the examination and the benchmark may not be met for reasons beyond our control.

In the limited cases where the substantial completion of fieldwork differs from the date MFDA staff leaves the Member's premises, the Manager must note this in our examination tracking system and the system does not allow the Manager to proceed unless they put in an explanation for the delay. Only Managers can extend the fieldwork in the examination tracking system. Senior Management reviews this information to ensure that the substantial completion of fieldwork only differs from the date MFDA staff leaves the Member's premises in rare and appropriate circumstances.

Nevertheless, to address CSA staff concerns, we will ensure benchmarks are measured from the date staff leaves the Member's premises.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response to ensure that benchmarks are measured from the date staff leaves the Member's premises. We ask that the MFDA inform BCSC staff when the benchmarks are clarified.

6. Compliance examination process

(a) Documented procedures and guidance

Background information

BCSC staff reviewed a variety of reference materials¹⁴ detailing procedures and providing guidance for Compliance staff.

Staff findings

BCSC staff found the procedures were generally up-to-date, sufficiently detailed, and well documented. The guidance materials are a good resource, providing examples and direction to Compliance staff.

Staff recommendations

None.

(b) Member selection process for compliance examinations

Background information

The MFDA completed its second round of compliance examinations during the Review Period and commenced its third round of examinations in January 2009. The PaRO's Compliance staff examine every BC member within a three-year cycle. Each examination includes the member's head office as well as a selection of branch and sub-branch locations. To assist in determining when each head office is reviewed within a particular review cycle, the MFDA uses a risk model. The risk model ranks the risk of each member in an objective manner taking into consideration inherent and external risks, as well as controls the member has in place. The model is updated on a regular basis or as circumstances change. MFDA staff use the risk rankings of members in determining the examination schedule. The highest risk members are generally reviewed before low-risk members. Other factors are also considered in selecting firms however, the risk rating is the key factor.

MFDA staff select branch and sub-branch offices for review based on a variety of factors including, but not limited to, the size of the branch, whether approved persons have dual occupations, the number and nature of complaints, any enforcement files, distribution of exempt products, extent of leveraging, previous examination findings, and any unique circumstances.

Prior to commencing the third round of examinations, the MFDA reviewed all aspects of its compliance processes in concert with examination results and trends to determine whether the level of compliance and stage of development of its

¹⁴ BCSC staff reviewed the following materials: *Compliance Officer Reference Manual*, *MFDA Internal Procedures - Compliance/Enforcement Referrals and information Sharing*, *MFDA Internal Procedures - Completing and Updating the Compliance Risk Model*, *Compliance Department Procedures Regarding Agreements and Undertakings*, and *Suitability Case Handling Guide*.

membership support any process changes. The MFDA concluded that for the third round of examinations, the MFDA would continue with the full scope compliance examinations and the three-year review cycle. However, the member's risk rating, in addition to determining the examination schedule, would become a significant determinant of the amount of work performed in an examination. For example, sample sizes and the number of branches selected for review are increased for higher risk firms and reduced for lower risk firms. Also, the scope of the testing would be reduced in lower risk areas where no deficiencies were found in the previous examination. Further, the MFDA has removed certain other low risk areas from the examination program.

Staff findings

Overall, BCSC staff found the MFDA's process for selecting and scheduling BC members for compliance examinations was reasonable for the level of compliance and stage of development of its membership.

BCSC staff reviewed the schedule for round three examinations and confirmed the schedule reflected the risk ratings of the firms.

Staff recommendations

None.

7. Compliance examination program and program execution

Background information

The MFDA maintains a compliance examination program that details all of the reviewing and testing procedures undertaken during a member examination. There have been several updates to the examination program since the first round of examinations to clarify existing procedures and incorporate new policies and regulations. This national program includes guidance on sample selection, including minimum sample sizes, and several templates that assist in the consistent application and documentation of the examination program.

For the second round of examinations, the MFDA continued conducting full scope compliance examinations on all of its members, but with more extensive examination procedures in identified high risk areas and less extensive examination procedures for low risk firms.

For the next round of examinations, the member's risk rating will become a significant determinant of the amount of work performed. This change was discussed in the previous section, II.C.6(b).

In addition to full scope compliance examinations, the MFDA uses focused or follow-up examinations in situations where high risk deficiencies were identified previously. These reviews are generally conducted by an independent monitor as part of an A&U or settlement agreement. Currently, the MFDA does not perform reduced scope compliance examinations because its examination program is mostly dedicated to key investor

protection issues. At this stage, MFDA management asserts that materially reducing the scope of work would not be in the public interest due to the examination results seen during the second review cycle. The MFDA will re-evaluate its compliance examination processes at the end of its third review cycle.

Staff findings

BCSC staff reviewed the examination program and the updates provided by the MFDA and found the program to be comprehensive. Amendments to the program included testing for compliance with new policies such as branch review requirements and information reporting requirements as well as member regulation notices on product due diligence, suitability, churning, and business continuity plans. BCSC staff are satisfied that the examination program has kept abreast of regulatory changes and provides adequate guidance to staff during the Review Period.

Also, BCSC staff find the MFDA's examination approach for the second and third review cycles reasonable for examining BC members.

Staff recommendations

None.

8. Review of compliance examination files

Background information

BCSC staff selected a sample of 4 head office compliance examination files from the 17 files completed during the MFDA's second round of examinations. The working paper files were reviewed for adequacy of planning, quality of work, timeliness of completion, and completeness of file documentation.

(a) Planning and risk assessment

The compliance examination program includes a section specifically for examination planning. This section details the preparation procedures to be completed before the commencement of fieldwork. The procedures are very thorough and, when completed, give the CO a good understanding of the member's operations. Information about the member is obtained and cross-checked from a number of sources. The planning stage is also used to identify areas that do not need to be reviewed in the current examination or alternatively areas of concern where additional program steps may be required.

Staff findings

BCSC staff found evidence that the planning was completed and signed off prior to the commencement of fieldwork in three of the four files that were reviewed. In the remaining file, there was evidence that preparations were started prior to the fieldwork; however, signoff was not obtained until after the commencement of fieldwork.

BCSC staff noted that when specific sections of the review program were omitted, they were removed because there had been no change since the last examination,

and that particular area had been fully reviewed without deficiency. Alternately, the section was not applicable to the member due to their business model.

The MFDA informed BCSC staff that, for the third round of examinations, they have amended their planning to achieve a better risk-based selection of samples and branch locations. In addition, they have increased sample sizes in high risk areas for high risk members.

Staff recommendations

None.

(b) Quality of the examinations

Staff findings

BCSC staff were generally satisfied with the quality of the examination files reviewed. The files were well documented and organized. Each file contained evidence of adequate planning and identification of key issues. Deficiencies noted in the modules had adequate supporting documentation and a deficiency form was completed and on file for each deficiency.

The quality of work was generally consistent across the files that were reviewed. The use of templates and set procedures within the examination program, staff training, and managerial review, assist in achieving this consistency.

One of the files in the sample was referred to Enforcement for their consideration. The referral process was appropriately followed. For the remaining three files, it was appropriate not to refer them to Enforcement.

In one file reviewed by the BCSC staff, 6 out of 10 leveraged accounts had a percentage of leverage-to-net worth greater than 30%. MFDA staff calculated and documented these percentages as per their file review. Despite the MFDA's internal procedure indicating that leveraging in excess of 30% of net worth raises a red flag, there was no documentation in the file to show that the staff had considered these figures and found them to be acceptable. This red flag was only raised in one of these six accounts..

When issuing an examination report, the MFDA details all of the deficiencies identified during the examination. The report does not specify which deficiencies the MFDA considers significant except by the order they appear in each section of the report.

Staff recommendations

Where red flags are identified when reviewing leverage accounts, the MFDA staff should clearly document their analysis of these accounts.

Priority: Low.

MFDA's response:

We agree that MFDA examination files should include appropriate documentation and analysis to support the conclusions reached. This examination was conducted shortly after the distribution of the MFDA's internal suitability guidelines and prior to the issuance of Member Regulation Notice MR-0069. Since this time, we have conducted significant training on the suitability guidelines and the associated documentation expectations where leveraging "red flags" are identified.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response. We ask that the MFDA provide BCSC staff with a copy of the materials from the recent training on the suitability guidelines and the associated documentation expectations for leveraging "red flags".

(c) Timeliness of completing the examinations

BCSC staff analyzed the examination process from initial planning to file closure. There are many parts to the examination process including planning, fieldwork, file preparation and report writing, managerial review, report issuance, and response analysis. The MFDA tracks the progress of examinations using the BPM system. Key dates are captured in the BPM system and used for reporting performance against benchmarks. The BPM system also tracks the length of time each examination file has been opened and the number of member responses received. As mentioned earlier, the system also produces monthly aging reports for management.

BCSC staff used the key dates from the BPM system and the signoff dates found in the sample of examination files to analyze the timeliness of the examination process. This was a difficult task for the following reasons:

- the time taken for each part of the process is not necessarily tracked for reporting purposes.
- different COs complete each section of the examination program, and submit them for managerial review, which can be at different times.
- branch reviews are often completed by COs in a different province.

Staff findings

Despite the challenges mentioned above, BCSC staff were satisfied that the time taken to complete the fieldwork, and prepare working papers and draft report for managerial review was reasonable.

MFDA staff are diligent in following-up on deficiencies and files are not closed until all deficiencies are adequately addressed. However, when compared with the results of the previous oversight review, BCSC staff continue to find instances where there is a significant amount of correspondence between the MFDA and the member before issues are clarified and resolved. The response process is time consuming for the MFDA staff and the member.

The MFDA has informed BCSC staff that they are continually looking to improve their effectiveness and ways to reduce the length of time a compliance exam

remains open. They have provided guidance to managers on communication with members. In addition, the MFDA released Bulletin #0355-C *Common Compliance Deficiencies and Appropriate Corrective Action* to give guidance to members on the MFDA's expectations for deficiency resolution.

At the end of the second review cycle, the MFDA provided guidance to its Compliance managers and staff to take a more directive approach by specifying in the report the required actions, where possible, and to initiate verbal communications and face-to-face meetings earlier in the deficiency resolution process. Accordingly, BCSC staff will monitor at their quarterly oversight meetings with the MFDA, the PaRO's progress to improve the effectiveness of its deficiency resolution process.

Staff recommendations

None, as the MFDA has undertaken to improve the effectiveness of its deficiency resolution process for the third review cycle.

Priority: Medium.

(d) File documentation

Staff findings

The working paper files were well documented and organized. Files contained cover sheets, completed checklists, deficiency forms, interview records, completed working papers, and supporting documentation. Deficiencies were noted in the working papers and were well referenced to the supporting documentation. Each file contained evidence of managerial review and signoff.

The only concern identified in relation to documentation was in the analysis of member responses. Each file contains a sheet detailing each deficiency, any follow-up required and whether the member's response is satisfactory. On two occasions, deficiencies were left off this list. On both occasions the deficiencies were adequately resolved however, they did not appear on the list.

Staff recommendations

COs should ensure that the analysis of member responses includes all deficiencies raised in the examination.

Priority: Low.

MFDA's response:

We acknowledge that a small number of findings were not included on the "Analysis of Member Response" working paper. As noted in the Oversight Report, the findings were adequately addressed by the Members in their initial response to the examination report and no further follow-up was required. We will, however, reiterate with our Compliance Officers that all deficiencies should be included on the Analysis of Member Response working paper to ensure complete documentation.

Staff comments and follow-up:

BCSC staff are satisfied with the MFDA's response.

9. Communication with Policy and Enforcement departments

Background information

Since the last oversight review, the MFDA has implemented systems to assist in the sharing of information between departments. BCSC staff reviewed a sample of management reports and examination files and interviewed MFDA staff about the communication between departments. Please refer to the detailed background information on the MFDA's internal communication processes at II.E.6.

Staff findings

BCSC staff found evidence of communication with Enforcement, Financial Compliance and Membership Services in the examination files reviewed. One of the files in the reviewed sample was referred to Enforcement. There was evidence on file that the referral had followed the written procedures. BCSC staff are satisfied with the communication channels and information sharing between the various departments.

Staff recommendations

None.

D. Membership

1. Introduction

T&C #6 of the BCSC RO requires the MFDA to admit as a member, all properly registered mutual fund dealers that satisfy its membership criteria; meet reasonable financial, operational, and proficiency requirements; have an appropriate business and ownership structure; and lack a detrimental disciplinary history. In addition, the criteria and processes for approving or denying membership, or imposing conditions of registration must be fair, consistent, and reasonable. Other membership-related responsibilities of the MFDA include reviewing and approving members' requests for corporate reorganizations and membership resignations, and suspending or terminating membership for disciplinary reasons.

For new membership applicants in BC, the review and approval process involves MFDA head office staff from Membership Services as well as Pacific region staff from Compliance. Staff at Membership Services completes the preliminary review and ensures receipt of all the required information from the applicant. The MFDA then assigns these applications to a Pacific compliance officer to complete the detailed review and prepare the Membership Recommendation Report (MRR) for head office review, and board consideration and approval.

For BC firms that wish to reorganize or resign from membership, head office staff from Financial Compliance review these requests. Staff submit recommendations for approval by the Director of Financial Compliance and the VP of Compliance. Member resignations also require board approval.

For BC members that are suspended or terminated for disciplinary reasons, head office Membership Services staff are responsible for dealing with members on this process. They will work with other MFDA departments such as Enforcement, Compliance and Financial Compliance, as appropriate.

2. Purpose and scope

BCSC staff assessed whether the MFDA's decisions to approve, deny or impose conditions on membership were fair, consistent, reasonable, and timely; and complied with the RO and applicable provisions of MFDA By-law No. 1. BCSC staff also evaluated whether the outcomes from the membership approval and hearing process were appropriate. To make these assessments, BCSC staff reviewed the MFDA's internal policies and procedures, the applicable provisions of MFDA By-law No. 1, and a sample of Pacific region membership application files and outcomes.

Finally, BCSC staff did not evaluate the MFDA's decisions related to member reorganizations, resignations, suspensions, and terminations in BC. For reorganizations and resignations, the MFDA's head office handled these requests and BCSC staff have assessed the associated risk as low. For suspensions and terminations, the MFDA's

process did not change since the last oversight review and there were no such actions taken against BC members during the Review Period.

3. Policies and procedures

Background information

BCSC staff discussed with the Director of Pacific Region the processes and the related changes since July 1, 2005 for new membership applications, including the associated hearing process; suspensions and terminations; and reorganizations and resignations. BCSC staff also reviewed written procedures, checklists, and review programs, where applicable.

Staff findings

MFDA's *Communications & Membership Services Reference Manual* outlines policies and procedures for reviewing membership applications, reorganizations, and resignations. The high-level procedures in this manual are clear and comprehensive. There are also detailed checklists that cover various processes for the new membership application reviews. For example, the *Membership Examination Program* checklist covers extensively the new Member's general operation, capital level, onsite review, referral arrangements, and policies and procedures. These checklists are relevant guidance for staff to follow when reviewing membership applications. There has been no significant change to the checklists or the procedures since our last review.

Staff recommendations

None.

4. Benchmarks

Background information

The MFDA has benchmarks for the new membership application reviews, but has no benchmarks for the reorganization and resignation reviews. The latter two processes depend on the member's schedule to reorganize, and on the time to transfer client accounts and submit audit reports, respectively. Please refer to II.G.4 for details of Membership Services' benchmarks for new membership application reviews.

Staff findings

BCSC staff are satisfied that the existing performance benchmarks for membership application reviews are reasonable.

Staff recommendations

None.

5. Review of membership application files

Background information

During the Review Period, the MFDA completed its review of three membership applications for the Pacific region. BCSC staff reviewed these membership application files, two in their entirety and one as a follow-up on a file that was pending MFDA board approval at the last oversight review.

Staff findings

The two files reviewed in their entirety were thorough and were completed in a timely manner by Pacific regional staff. The review files were well documented and evidenced managerial review of the work. The regional review process appeared effective, and showed evidence to support conclusions. The files also demonstrated coordination between the various MFDA departments and the BCSC.

From the three Pacific regional files reviewed, BCSC staff were satisfied that the MFDA's decisions to approve, deny and impose conditions on membership were fair, consistent, reasonable, and timely; and complied with the RO and applicable provisions of MFDA By-law No. 1. BCSC staff were also satisfied with the overall outcomes from the MFDA's new membership application approval and hearing process.

Staff recommendations

None.

6. Review of member suspensions and termination files

During the Review Period, there were no membership suspensions or terminations of BC members through the discipline process. Therefore, BCSC staff will assess the MFDA's decisions and outcomes for fairness, reasonableness, consistency, and timeliness in the next oversight review.

IV. Prairie Regional Office

A. Summary

1. Background

The PrRO has two onsite operational departments; Investigations and Compliance. The Director of Prairie Region oversees the operations of the Compliance Department in the PrRO and has, very recently, been involved in providing input in the enforcement process. During the course of the Review Period, there have been three different individuals in the role of Director of Prairie Region. The MFDA implemented the new process of including the Director of Prairie Region in the enforcement process in September 2008.

2. Assessment of findings

ASC, MSC, SFSC staff reviewed the operations of the PrRO; Investigations, Compliance and Membership. ASC, MSC, and SFSC staff identified areas in Compliance and Enforcement that require improvement and the MFDA should take action to address these concerns.

B. Enforcement

1. Introduction

Under T&C #7 of the ASC, MSC and SFSC ROs, the MFDA shall enforce compliance by its members and their APs with the Rules of the MFDA and the MFDA shall cooperate with each jurisdiction in ensuring compliance with applicable securities legislation relating to the operations, standards of practice and business conduct of members and APs. T&C #8 of the ROs states that the MFDA shall have the right to and shall appropriately discipline its members and their APs for violations of MFDA Rules and shall cooperate with the ASC, MSC, and SFSC in the enforcement of applicable securities legislation.

The Enforcement Department is responsible for identifying violations of MFDA regulatory requirements and other applicable securities legislation by its members and APs, gathering the necessary evidence to prove the violations, and finally taking disciplinary action against those members or APs for violations of MFDA Rules.

2. Purpose and scope

The purpose of the oversight review is to assess and determine if the Enforcement Department has the resources and processes in place to ensure it performs its regulatory functions effectively and efficiently. ASC, MSC and SFSC staff:

- reviewed the adequacy of regional staffing, resources, and training.
- evaluated the efficiency and effectiveness of the MFDA's enforcement processes.
- evaluated whether the Enforcement Department is complying with the T&Cs in the ROs.
- reviewed whether the MFDA met its internal performance benchmarks in addition to whether the benchmarks themselves were adequate and reasonable.

ASC, MSC and SFSC staff interviewed (i) the Vice President of Enforcement, (ii) the directors of the Enforcement groups, (iii) both PrRO investigators, (iv) the Manager of Investigations, Pacific and Prairie Regions located in Vancouver, (v) the Director of Prairie Region, (vi) one manager of Case Assessment, (vi) one CAO, and (viii) one CAA.

ASC, MSC and SFSC staff also reviewed MFDA internal policies and procedures and a sample of case assessment and investigation, and litigation files.

Because the MFDA's Case Assessment group is located at head office, II.D.6 details ASC, MSC and SFSC staff's findings and recommendations for Prairie regional matters.

3. Department structure

Background information

At the PrRO, the Enforcement group consists of two investigators who reported to the Director of Investigations located in Toronto for the majority of the Review Period. The MFDA recently created a manager of investigations position at the PaRO in Vancouver. The PrRO's investigators now report to this manager. For a portion of the Review Period,

one investigator was on leave (February 2008 to March 2009) and the other investigator position remained unfilled for a period of approximately ten months. The Director of Investigations provides in-person support to the PrRO's investigators by traveling to Calgary on a quarterly basis and the Manager of Investigations, Pacific and Prairie Regions provides in-person support on an ad-hoc basis. The Director of Prairie Region does not manage the day-to-day case work of the PrRO's investigators; however, since 2008 the role now provides input into case escalation decisions. The investigators report directly to the Manager of Investigations in Vancouver and to the Director of Investigations in Toronto.

There is no Case Assessment staff or Enforcement Counsel located in the PrRO. Case Assessment staff and Litigation staff are all located in the MFDA's head office; however, the MFDA has recently dedicated one CAO to review the complaints and METS filings that originate in Alberta, Manitoba, and Saskatchewan. The MFDA began receiving filings through METS during the course of the Review Period.

4. Staffing resources and training

(a) Investigations staffing, management, and decision making

Background information

T&C #12 of the ROs requires that the MFDA maintain a sufficient complement of qualified staff and an adequate supervisory structure for the effective monitoring and enforcement of compliance with its Rules.

Staff findings

ASC, MSC and SFSC staff are concerned that the PrRO may not have a sufficient complement of qualified investigators to effectively and efficiently address the investigations that originate in the Prairie region.

ASC, MSC and SFSC staff determined that a number of investigation files originating in the Prairie region were conducted by investigators located outside the PrRO. According to the information provided by the MFDA, the following occurred during the Review Period:

Table 1: Prairie Region (PrR) Investigations Conducted by the PrRO's Investigators During the Review Period

Province	Total Investigations Originating in Region	Total PrR Investigations Conducted by PrRO's Investigators
AB	22	3
MB	14	4
SK	10	5
Total	46	12*

* - the PrRO's investigators conducted two additional investigations that originated in provinces outside of the Prairie region bringing the total investigations conducted by the PrRO's staff to 14.

ASC, MSC and SFSC staff recognize that the PrRO was not fully staffed during the entire Review Period; however, the data in Table 1 above raises concerns about whether the PrRO's Investigations group is adequately staffed.

ASC, MSC and SFSC staff are also concerned that the MFDA has decided to operate the Investigations group in the PrRO without onsite management of case work or onsite decision making. ASC, MSC and SFSC staff have taken into consideration that the MFDA has recently included the Director of Prairie Region on the ERC; however, ASC, MSC and SFSC staff continue to be concerned that there is no day-to-day onsite case management or decision making authority.

If there is sufficient activity in the Prairie region in relation to a regulated matter, it would be expected that the MFDA would ensure that the PrRO's staff be knowledgeable of the issues and involved.

Staff recommendations

ASC, MSC and SFSC staff recommend that the MFDA consider (i) whether its current staffing levels of the Investigation group in the PrRO is adequate, (ii) whether onsite management is required to oversee the PrRO's Investigations group, and (iii) whether the processes it has created to assign cases originating in the Prairie region is appropriate given the quantity of work that exists in the region.

Priority: Medium.

MFDA's response:

In response to this recommendation, we have increased our staffing by adding and filling the new position of Manager, Investigations, Prairie Region. This position manages the two existing investigators and directly investigates cases, generally those of a novel or more complex nature. We will monitor staffing going forward to ensure that staff coverage is adequate and, where appropriate, files are assigned in the Prairie Region. Files may be assigned outside the Prairie Region due to expertise in specific matters, potential conflicts, workload, or absences of staff.

Staff comments and follow-up:

ASC, MSC, and SFSC staff are satisfied with the MFDA's response. We will continue to monitor the appropriateness of the MFDA's staffing levels of the PrRO.

(b) Staff training

Background information

Please refer to the background information at II.D.4 for Enforcement staff training.

Staff findings

The PrRO's investigators are provided adequate training resources and have access to training sessions and mentoring opportunities.

Staff recommendations

None.

5. Investigations group

(a) Investigations process and documented procedures

Background information

Cases are referred to Investigations from Case Assessment, the provincial securities commissions, other internal MFDA departments, or other sources. The Director of Investigations (head office) or Manager of Investigations (Pacific Regional Office) will assign the file to an investigator based on the file's priority, investigator workload, and investigator experience.

ASC, MSC and SFSC staff reviewed the Investigations group's documented procedures.

Staff findings

The investigation process at the PrRO appears to operate efficiently.

The written procedures and guidance surrounding the investigation process are adequate. The various procedures manuals are comprehensive and provide adequate guidance regarding the investigative process and staff's roles and responsibilities.

Staff recommendations

None.

(b) Review of investigation files

Background information

ASC staff reviewed 17 investigation files, MSC staff reviewed eight investigation files and staff of the SFSC reviewed 10 investigation files. These files related to members or APs resident in the Prairie region, but were completed by MFDA investigators located in any one of the PrRO, the PaRO, and the MFDA head office.

Staff findings

MFDA management assigned the files in a satisfactory amount of time. Generally, investigation files had an appropriate amount of detail and contained adequate supporting documentation. The investigation report summarized the investigation activities undertaken, the evidence obtained during the investigation, and the recommendation. The files contained evidence that MFDA management reviewed the investigation report.

The investigations were generally completed within the MFDA's defined benchmarks.

Please refer to II.D.6(c) for findings related to warning calls and warning letters.

Staff recommendations

Please refer to II.D.6(c) for recommendations related to warning calls and warning letters.

(c) Location of files

Background

According to MFDA written policies and procedures, investigations that MFDA staff conduct for files originating in the Prairie region are to be housed at the PrRO upon completion of the investigation.

Staff findings

Four out of the initial 13 investigation files requested by ASC staff were not onsite and were filed in the MFDA's head office after they were closed, contrary to MFDA policies and procedures. MFDA procedures require that upon closure, such files are sent to the PrRO; in these cases, this did not occur. Additionally, one of two litigation files requested by ASC staff was not onsite.

During the oversight review, ASC staff brought this to the attention of MFDA management. MFDA management took immediate steps to ensure that the requested files were transported to the PrRO in a timely manner for our review. The MFDA also took additional measures to ensure that all other files that were to be filed in the PrRO were filed correctly.

Staff recommendations

The MFDA must ensure that files are accessible and housed in the appropriate location.

Priority: Medium.

MFDA's response:

We implemented additional internal control procedures at the time that this situation was brought to our attention and we will continue to monitor to ensure that the procedures satisfactorily address the issue.

Staff comments and follow-up:

ASC staff are satisfied with the MFDA's response.

C. Compliance

1. Introduction

T&C #7(A) of the ROs states the MFDA shall enforce compliance by its members and APs with the Rules of the MFDA. T&C #7(B) states, (i) the MFDA shall conduct periodic reviews of its members and the member's APs to ensure compliance, and (ii) that the MFDA shall conduct such reviews at a frequency requested by the Commissions or Commission staff.

MFDA Compliance staff conduct onsite compliance examinations of its members and their APs. The MFDA's compliance examination program consists of three-year rounds whereby it performs one examination per member during a round. For the majority of the Review Period, Compliance was conducting its second round of examinations.

As noted earlier, the Director of Prairie Region oversees Compliance staff in the PrRO.

2. Purpose and scope

The purpose of this part of the oversight review was:

- to review and evaluate the MFDA Compliance Department's structure and resources, including staffing, to ensure it performs its regulatory functions effectively and efficiently.
- to evaluate the adequacy of the performance measurement benchmarks for examinations and determine whether the MFDA met them.
- to assess the adequacy, timeliness, and quality of examinations performed by Compliance staff.
- to assess whether deficiencies reported during the first round of examinations were properly followed up and addressed by Compliance staff.

In order to accomplish the objectives, ASC, MSC and SFSC staff interviewed (i) the VP of Compliance, (ii) the Director of Compliance, (iii) the Director of Prairie Region, (iv) the Manager of Compliance, and (v) two PrRO COs.

In addition, ASC, MSC and SFSC staff reviewed Compliance's policies and procedures, Member Compliance Examination Program (program), and performance measurement benchmarks. ASC, MSC and SFSC examined samples of examination files to assess the quality, adequacy, timeliness, efficiency, and effectiveness of the compliance reviews performed by the Compliance Department.

3. Department structure

(a) Branch risk identification and coverage

Background information

The PrRO's Compliance Department consists of the Manager of Compliance, one senior CO, and five COs. The Manager of Compliance reports directly to the

Director of Prairie Region and indirectly reports to the Director of Compliance and VP of Compliance as required.

The PrRO's Compliance Department is responsible for conducting examinations in Alberta, Manitoba, and Saskatchewan.

In conjunction with examining the member's head office, the MFDA examines various branch locations. The PrRO's Compliance staff may take part in the examination of a member whose head office is not located in the Prairie region by conducting an examination of a branch in the Prairie region.

The MFDA has created a risk model that ranks members with an overall risk rating; however, the MFDA does not track the risk profiles of dealer activities for each branch. The MFDA's approach to member compliance has focused on examining the member's head office, in addition to a sample of its branch locations across the country, once every three years. The MFDA then relies on the member's board of directors, Ultimate Designated Person, compliance officers, and branch managers to maintain compliance throughout the organization, including ongoing compliance at the branch office level.

The composition of the market in Alberta, Manitoba and Saskatchewan is such that the majority of the APs conduct business in branch office locations. The ASC, MSC and SFSC recognized the MFDA to ensure compliance in their provinces. The MFDA must ensure that it considers the risks inherent to this market composition appropriately. The following table illustrates the number of head offices in each province compared to the number of branch or sub-branch locations:

Province	Head Offices	Approximate Branches/Sub-branches
Alberta	7	2000
Manitoba	7	700
Saskatchewan	4	800

Staff findings

During the Review Period, the MFDA conducted 10 member head office examinations and 31 branch examinations in Alberta, seven member head office examinations and six branch examinations in Manitoba, and six member head office examinations and seven branch examinations in Saskatchewan.

ASC, MSC and SFSC staff are concerned that the MFDA does not factor in the different types of risks associated with overseeing a population of branch offices that are not in close proximity to their head offices. The distance between the branch and the member's head office potentially creates an operational risk that the MFDA should take into account. Performing branch audits, therefore, is an integral part of ensuring that risks of a branch align with the risks of a firm as a whole. As such, ASC, MSC and SFSC staff are concerned with the number of branch examinations in the Prairie region.

The MFDA is recognized by the ASC, MSC and SFSC to, among other things, ensure compliance by its members in those specific jurisdictions. ASC, MSC and SFSC staff expect that the number and frequency of the MFDA's examinations in each jurisdiction are reasonable, justifiable, and that they ensure member compliance within all three provinces.

Staff recommendations

T&C #7(B) of the ROs states that the MFDA shall conduct member examinations at a frequency requested by the Commissions or Commission staff. To date, ASC, MSC and SFSC staff have deferred mandating a specific examination frequency to the MFDA to conduct examinations in the respective provinces. Given the stated concerns, ASC, MSC and SFSC staff request that the MFDA create a plan that will ensure increased branch coverage in order to address the risks specific to the Prairie region.

Priority: High.

MFDA's response:

We acknowledge the importance of examining branch locations. Members' use of branch locations is consistent across Canada and is not exclusive or concentrated in the provinces of Alberta, Saskatchewan and Manitoba. MFDA Members have over 75,000 APs and over 15,000 branch locations. While these figures underscore the importance of branch examinations as a key element of our compliance program, they also illustrate that our compliance efforts must be primarily focused at the Member level, as it is neither practical nor effective to look to improve the level of compliance one AP at a time or one branch at a time.

Since commencing examinations 7 years ago, the MFDA has performed over 1000 on-site examinations. To ensure best practices, we continuously compare the proportion of branch examinations to head office examinations that we conduct compared to other Canadian and US SROs.

The MFDA processes are focused on the risks at branch locations. The examination program includes extensive client file testing specifically targeted at client account activity that occurs primarily at branch locations. Key components of our Member examinations are on-site branch examinations. We specifically review all available information including client complaints, assets under administration, the extent of leveraging and the sale of exempt securities at the branch, prior regulatory examinations and the Member's own branch examinations to ensure that higher risk branches are examined and the specific risk areas are reviewed. In the absence of any specific risk factors, we also consider proportional geographic coverage per cycle to adequately cover each provincial jurisdiction. We complete these branch examinations in conjunction with the Member head office examination, as it facilitates the identification of systemic issues that may exist with the Member's branch supervision procedures

generally and ensures that those issues are addressed across the Member rather than just at a particular branch.

The MFDA has also taken numerous other steps to improve the level of compliance at branch offices, including providing detailed requirements for Members to conduct examinations of all their branches in compliance with Policy No. 5 and providing detailed guidance on supervisory requirements and suitability guidelines. These measures have significantly raised the standard of compliance and supervision at branch offices since Members have been subject to the jurisdiction of the MFDA.

The Oversight Report notes that one specific risk to be considered is the distance between the branch location and its head office. While we understand every provincial securities commission's desire for more branch examinations to be conducted in their province, we have not identified any basis for the conclusion that the distance between head office and branch offices is a determining risk factor. Our compliance and enforcement findings are relatively common across provinces. Risk at branch locations is not a function of distance from head office, but rather actual supervision and activity conducted at branch locations. The MFDA examination program currently addresses those risks.

We will continue our efforts to balance the need to select branches based on risk to ensure we fulfill our national investor protection mandate, while also striving to meet the expectations of the various provincial securities regulatory authorities to perform an appropriate number of examinations in each jurisdiction.

Staff comments and follow-up:

ASC, MSC and SFSC staff agree with the MFDA that conducting branch examinations is important; however, the MFDA should consider the importance of conducting on-site branch examinations outside of its scheduled triennial examinations and separately from member head office examinations. The MFDA must ensure that its presence in Alberta, Manitoba, and Saskatchewan is visible, effective, and promotes compliance not only at the head office level but also at the branch office level.

We will continue to work with the MFDA to ensure that it provides sufficient coverage of the PrRO's mutual fund dealer populations and that it takes the risks inherent to the regional market compositions into account.

4. Staffing resources and training

(a) Deployment of staff

Background information

For most of the Review Period, the PrRO had a fully staffed Compliance Department, which included six COs and one manager.

During the planning stage of an examination, the Manager of Compliance will assign COs to an examination. Generally, examinations are conducted by teams of

three COs, and sometimes all six depending on the size of the member. Each CO is responsible for completing a portion of the examination program.

The MFDA conducts regularly scheduled examinations of each of its members and does not conduct targeted (focused on one specific issue at a Member) examinations. Although the MFDA conducted some follow-up examinations in other regions, the PrRO's Compliance Department did not perform these types of visits during the Review Period. ASC, MSC and SFSC staff were advised that the MFDA Enforcement Department has the ability to react to issues that are identified outside of the examination process and in cases where further monitoring is required once issues have been identified, the MFDA may require a member to retain an Independent Consultant through an A&U.

Staff findings

ASC, MSC and SFSC staff are concerned that the MFDA's processes hinder it from conducting more examinations in Alberta, Manitoba, and Saskatchewan notwithstanding that the PrRO's Compliance Department is fully staffed and equipped with experienced personnel.

ASC, MSC and SFSC staff found the MFDA's standardized examination program execution and staff allocation process, limited the number of examinations the Prairie region's Compliance Department was able to conduct during the Review Period. ASC, MSC and SFSC staff has considered that the MFDA only conducts scheduled examinations within its triennial rounds that consist of a full examination for every head office or branch it reviews. These examinations sometime require all six COs to participate in the examination because of the size and scope of the review. The adoption of targeted reviews may require less time and resources that would allow for an increase in coverage and the number of reviews the group could perform.

During the Review Period, the PrRO's Compliance staff conducted an average of approximately three examinations per CO, per year (including both head office and branch locations). This average was derived by taking the number of examinations performed in total and dividing by the number of Compliance staff in the region.

Additionally, MSC staff note that the conduct of compliance matters arising in Manitoba is currently shared between the PrRO and MFDA's head office in Toronto. This raises concerns for MSC staff about the adequacy of the resources at the PrRO. In addition, the sharing of responsibility for regulation of a market between two separate MFDA offices has the potential to result in inconsistent treatment of participants.

Staff recommendations

The MFDA should consider (i) how it allocates the PrRO's Compliance staff to each examination, (ii) if any of its current processes could be improved to effect an increase in the number of examinations it could perform in the future, and (iii) if any

of its current processes could be improved to ensure that the PrRO's Compliance Department is responsible for overseeing all Prairie region members.

Priority: High.

MFDA's response:

The MFDA does perform focused examinations in certain situations where appropriate and we intend to continue to increase the use of focused or follow-up examinations. However, we often achieve many of the same objectives of focused examinations through other processes. One of the situations where a focused examination is often appropriate is to follow-up on specific, previously identified deficiencies that are of a high-risk nature. In many of the cases where a follow-up examination would be appropriate, the MFDA ensures that this examination is conducted by an Independent Monitor as part of an Agreement and Undertaking or Settlement Agreement. This approach has certain advantages, as it allows MFDA resources to be available for other examinations, while also ensuring that the cost of the follow-up examination is borne by the specific Member rather than by the membership as a whole. The MFDA's compliance process is primarily a proactive process to assess Member compliance and identify previously unknown issues. The MFDA does have reactive processes as well to address issues that arise from complaints or other intake sources. These reactive processes are primarily conducted through Enforcement and require that Member supervision and the possibility of systemic issues be assessed. These processes include on-site visits, where appropriate, and collaboration with Compliance staff.

The number of examinations that can be performed by the MFDA is dependent on the number of MFDA staff and the scope of examination procedures. Performing more examinations would require significant staff additions or material reductions to the examination procedures, which directly target critical investor protection issues including suitability and supervision.

The Oversight Report states that: "Compliance staff conducted on average approximately only three examinations per CO per year", which has been determined by taking the number of examinations performed in total and dividing by the number of Compliance staff in the Region. This simplistic calculation is misleading. Each Compliance staff person in the Prairie Region participates in between 10 to 20 examinations a year.

With respect to sharing Compliance responsibilities for matters arising in Manitoba, the MFDA is a national organization and all offices participate in compliance matters arising with Members with operations in more than one Region. The MFDA is responsible for ensuring the protection of investors in all Recognizing Jurisdictions and, accordingly, is able to address problems with Members nationally to the maximum benefit of all investors. Integrating staff from various offices does not lead to inconsistent treatment but, instead, to greater consistency amongst all offices. By integrating staff from various offices in conducting examinations, staff is able to share knowledge and experience, which further ensures all investors subject to MFDA

jurisdiction are treated consistently. MFDA processes are specifically designed to avoid the creation of department or regional silos and to prevent inconsistent treatment of Members.

As much as possible, we will endeavor to have the PrRO Compliance Department oversee Prairie Region Members.

Staff comments and follow-up:

It is noted that the MFDA has a process in place to perform focused examinations. It is also noted that the PrRO did not conduct any focused examinations during the review period. We will continue to monitor how the PrRO performs examinations through our ongoing oversight.

In the one instance in Alberta during the review period where the MFDA imposed an independent monitor, the member continues to have significant compliance issues. After the member engaged independent monitors on three separate occasions (twice imposed by the MFDA and once voluntarily), it has been unable to correct all of the deficiencies identified by the MFDA. Staff note that the MFDA has indicated it will begin to charge for excessive attention in addition to its use of independent monitors. Staff will continue to monitor the effectiveness of the MFDA ensuring compliance of its members through its new process of charging for excessive attention and use of independent monitors.

The MFDA should consider alternative approaches to its examination process that are effective at promoting member compliance. In addition to its regularly scheduled examinations, performing focused, risk-based and targeted examinations would lead to more efficient staffing allocation outcomes and an increase in the number of examinations and membership coverage. We will continue to work with the PrRO to ensure it is conducting efficient and effective compliance oversight of its membership.

(b) Training

Background information

New staff receive information relating to MFDA policies and procedures, the MFDA Rulebook and MFDA internal information systems. Ongoing training occurs in the form of lunch-and-learn sessions along with at least one annual formal training session at head office for all Compliance staff.

Staff findings

Compliance staff are provided satisfactory training resources and have adequate access to training sessions and mentoring opportunities.

Staff recommendations

None.

5. Benchmarks

(a) Length of benchmarks

Background information

Please refer to the background information at II.E.4(b) for Compliance's national benchmark for issuing compliance examination reports.

Staff findings

The PrRO's Compliance Department met its benchmarks throughout the Review Period and issued approximately 70% of its reports to its members within 15 weeks and the remaining 30% within 22 weeks. However, ASC, MSC and SFSC staff consider 22 weeks, and even 15 weeks, to be too long for the MFDA to be responsive and timely in addressing member deficiencies.

These timeframes are not sufficiently stringent. The issuance of deficiency reports this long after the completion of fieldwork jeopardizes the importance and effectiveness of the review. The MFDA cannot effectively convey the importance of its findings to its members when more than four months elapses between the completion of fieldwork and the issuance of the report.

ASC, MSC and SFSC staff recognizes that MFDA staff verbally notify the member that it should begin correcting its deficiencies during the exit meeting. However, the MFDA does not give the member a formal record of its deficiencies until the examination report is issued. In addition, the member does not provide the MFDA with written assurances for any necessary corrective action until the member formally responds to the examination report.

Staff recommendations

The MFDA should reconsider the appropriateness of its compliance benchmarks. While doing so, the MFDA should consider: (i) if it should provide its members with a formal record of deficiencies at the completion of fieldwork or at the exit meeting, and (ii) if any of its other current policies and procedures could be amended in order to shorten the applicable benchmarks.

Priority: High.

MFDA's response:

We certainly agree that it is important to try to issue our examination reports as promptly as possible and we expend considerable effort to achieve this objective. However, we do not feel that the timing for issuing examination reports has jeopardized the effectiveness of our examinations.

During an MFDA compliance examination, the Member is continually informed of the deficiencies identified throughout the examination, formal exit meetings are held at the conclusion of fieldwork at each location visited, and a consolidated exit meeting is also held at the Member's head office to review all findings from all locations visited.

Members are provided with specific details on the deficiencies identified to date at these exit meetings, including specific lists of client accounts and transactions where issues have been identified.

The MFDA's examinations include significant focus on issues that are often complex and require extensive analysis, professional judgment and management review. This includes, in many cases, assessing hundreds of client accounts for investment suitability and leveraging suitability and reviewing hundreds of transactions in possible cases of excessive trading. These are key investor protection issues. The time required to fully document all the examination work performed on hundreds of potential issues and fully analyze, review, consolidate and report the issues from five on-site examinations is significant. In our view, 15 weeks is a very reasonable benchmark to complete this work.

It is also important that the 15-week benchmark be viewed in the proper context. The compliance examination team does not work exclusively on one examination file during that period. Staff resources need to be utilized to the fullest to achieve our regulatory objectives. Accordingly, all Compliance staff and Managers are working on numerous files at any given time at various stages including Manager review, planning, head office fieldwork, branch fieldwork, review of responses, review of action plans, test plans and test results for Member's subject to settlement agreements, etc. We manage this workload effectively to ensure resources are fully utilized, our objectives are achieved, and all work is completed within established benchmarks.

The examination report is the "formal record" of the deficiencies and is a primary and key document relied on in enforcement proceedings. Accordingly, the examination report is not issued to the Member until it has been subject to a quality control process by senior Compliance staff. The quality control review allows for consistency in reporting issues and accuracy and completeness of deficiencies identified. If we were to issue a "report" at the exit meeting, it may be incomplete and inaccurate.

We will continue to monitor the appropriateness of our benchmarks in the future.

Staff comments and follow-up:

We will continue to work with the MFDA through our ongoing oversight to ensure its benchmarks are appropriate and are achieving timely and responsive regulation of its membership.

6. Compliance examination program and process

(a) Program execution

Background information

MFDA Compliance has developed a member compliance examination program (program). MFDA staff use the program as a guide to conducting field examinations. The program provides guidance to MFDA staff and instructs COs to document their findings.

Staff findings

ASC, MSC and SFSC staff reviewed the program to ensure it adequately addresses risks and regulatory concerns, especially recent regulatory issues or developments. The MFDA made major revisions to its examination program after the first round of examinations and, most recently, after the completion of its second round. The MFDA may make significant changes to its program during the ongoing round; however, it makes most changes prior to the beginning of each new round.

As noted above, MFDA Compliance does not conduct targeted examinations (examinations focused on one specific issue) of its members. Instead, Compliance staff complete all applicable portions of the program for each member examination.

ASC and MSC staff found that the MFDA Compliance does not use a targeted examination strategy even when specific issues are referred to them. In one instance, the MSC and MFDA held discussions regarding concerns the MSC had with a member firm. A subsequent referral was made to the MFDA. Instead of carrying out a targeted examination of the referred issues, the MFDA responded by moving up the regularly scheduled examination of that member in the round. The MFDA then conducted five full branch examinations and the head office examination of the member. Rather than targeting the particular issue of unsuitable leveraging, the MFDA chose to execute the full compliance program. The file review(s) completed by staff during the oversight review suggested that the MFDA did not make significant program changes or increase its sample sizes to address the issues referred by MSC staff.

Additionally, ASC staff found that in 67% of head office examination files reviewed, the MFDA did not place sufficient emphasis on the testing of repeat deficiencies from past examinations. In these files, the MFDA Compliance staff documented that past deficiencies had been reviewed prior to conducting the subsequent examination, but it did not appear that Compliance conducted any additional testing or adjusted the sample sizes in those higher risk or repeat deficiency areas.

The MFDA's compliance program should be designed to be effective and responsive while ensuring MFDA staff can appropriately apply it to address risk areas.

Staff recommendations

The MFDA should reconsider the design of its program to allow for the use of targeted, risk-based, or follow-up examinations of its members in appropriate cases when (i) a specific issue has been referred by an outside source, or (ii) identified internally.

Priority: High.

MFDA's response:

As previously noted, the MFDA does perform targeted examinations. We disagree with the assertion that MFDA Compliance does not perform a targeted examination where specific issues are referred to them. With respect to the MSC example, the MSC did not refer a specific issue of unsuitable leveraging, but rather communicated several concerns covering a range of issues. In written correspondence provided to the MFDA, MSC staff suggested a full branch review might uncover additional issues. All of the issues referred by MSC staff were considered in the examination planning. The MFDA also informed MSC staff of its intentions to perform a complete compliance examination at the time of the referral.

As a result of the concerns expressed by MSC staff, the branches identified by the MSC were specifically selected for examination and the minimum sample sizes for the testing of leveraged accounts were doubled at all locations examined. This was clearly documented in the planning section of the examination file. The sample sizes for leveraged accounts were further increased in the field whereby any leveraged accounts identified through other examination procedures were added to the initial sample of leveraged accounts and tested in accordance with the leverage examination procedures. The result was that the total sample size of leveraged accounts examined was increased to 200, including a total of 73 at the two branches in Manitoba. These sample sizes and the testing performed are clearly documented in the examination file and reports.

When significant issues are identified, Compliance does not limit its review to only one issue, as, frequently, when there is a significant breakdown in one process, there are other processes equally affected. Recent issues experienced in the United States indicate regulators who are so narrowly focused on one issue have missed more serious and extensive concerns.

We further note that had we only performed an investigation of the Member's branch locations in Manitoba, resolution would only have addressed issues with Manitoba investors without identifying or resolving the issues identified with investors in the other provinces. Our mandate is to protect investors in all Recognizing Jurisdictions and the most efficient and effective way to do so was to assess the extent of the entire issue by performing a Member examination and then to accomplish a resolution for investors in all recognizing provinces.

It should be noted that MFDA Enforcement did conduct a diligent, on-site investigation at a Winnipeg branch of the Member, and locations in other provinces, as a result of an anonymous complaint forwarded to us by the ASC.

ASC staff noted that "sufficient emphasis" on repeat findings was not placed on the basis that the MFDA did not increase the sample sizes or conduct additional testing for repeat deficiencies. The MFDA does ensure that the examination includes test procedures to address all deficiencies from the previous examination. The core examination program includes procedures to address all commonly identified deficiencies. Where the

examination program does not include procedures to address a specific previous deficiency, MFDA staff adds procedures to the examination to test the deficiency.

The MFDA does increase sample sizes in certain cases, including examinations of high risk Members or areas identified as high risk during an examination and instances where additional testing is needed to ensure the sample selected is sufficiently representative of the Member's operations. If a repeat deficiency is identified in the minimum sample which is representative of the population, it is not necessary to increase the sample size as the deficiency can be appropriately supported.

Staff comments and follow-up:

Targeted examinations are focused on one specific issue at a member or location and may be initiated for cause. As stated by the MFDA above, “(MFDA) Compliance does not limit its review to only one issue, as, frequently, when there is a significant breakdown in one process, there are other processes equally affected.” While the MFDA may be able to cite examples where it utilized follow-up examinations in other regions, it did not conduct any follow-up or targeted examinations in the Prairie Region during the review period. This portion of the Oversight Report details the activities of the Prairie Region Office, including how it interacts and cooperates with the MFDA’s head office. The MFDA should ensure that PrRO staff is employing appropriate examination techniques including targeted, focused, and risk-based examinations.

MSC staff note the MFDA’s response with respect to the ability to conduct targeted examinations when significant investor protection issues are referred to them, and will continue to monitor this issue through our ongoing oversight.

ASC staff acknowledge the MFDA’s comments regarding repeat deficiencies and sample sizes. We will continue to work with the MFDA through our ongoing oversight to ensure the identification of key risk areas during its examination of members, such as repeat deficiencies, is effective.

(b) Sample selection

Background information

Compliance staff are required to select a minimum sample size for each of its program modules. These samples include (i) the number of branch locations that Compliance will examine in conjunction with the member’s head office, (ii) the number of APs that Compliance will interview during the examination, (iii) a number of client account types and transaction types, and (iv) various other types of documents related to aspects of the member’s operation. Compliance tests these samples to identify whether the member is complying with MFDA regulatory requirements and other applicable securities legislation.

During the planning stage, Compliance staff may increase the sample sizes from the required minimums in cases where the member has a high risk rating. The MFDA requires its Compliance staff to document the rationale for any sample size deviations.

During fieldwork, Compliance staff may also increase sample sizes when non-compliant trends are identified or if staff feel increased testing is warranted.

Staff findings

ASC, MSC and SFSC staff found that the MFDA's sample selection process may have some weaknesses in its application by the PrRO's Compliance staff. During the course of the review, ASC, MSC and SFSC staff identified the following areas of concern:

(i) Consistent sample sizes vs. member sizes

The MFDA's sample sizes are not appropriate for its larger members. Minimum sample sizes range from 10 to 20 in most categories of the MFDA's program. Compliance staff rarely deviate from the minimum sample size. In the situations where sample sizes were increased, Compliance staff typically only increased by 10 records in the applicable categories of testing, no matter the size of the member or number of client accounts. Additionally, Compliance staff typically only interview two APs per location. This means that, during an examination in the Review Period, which consisted of the head office and typically two to three branch locations, (i) the MFDA interviewed, at a minimum, eight to ten APs for a member consisting of hundreds of APs, and (ii) the MFDA sometimes tests approximately 100 client accounts for members that may hold thousands of client accounts. The MFDA compliance program specifies a mandated minimum sample size that does not account for difference in member size. ASC, MSC and SFSC staff have considered that the MFDA has expressed in previous oversight report responses that its sample selection methodology is judgmental, not representative; however, ASC, MSC and SFSC staff believe the MFDA must appropriately factor in the member's size in terms of (i) number of locations and APs and (ii) number of client accounts when it tests a member's operations. The fact that Compliance staff typically select the minimum sample required suggests that the MFDA's sampling methodology is not judgmental, but mandated in its program.

(ii) Increasing sample sizes in the field

ASC staff found instances where the PrRO's Compliance staff did not increase sample sizes in the field when they identified serious unsuitable leveraging issues; Compliance staff could have reviewed more client accounts for two particular APs when they identified that the APs had been using unsuitable leveraging strategies. Instead, Compliance staff elected to report the two specific instances of unsuitable leveraging in the examination reports without identifying if the practice of unsuitable leveraging was a trend for each of the two APs through the compliance examination process. In one of these two examples, Compliance did not increase its sample size because the AP had only transferred five client accounts to a new member after the AP's transfer of registration was approved. The MFDA found leveraging issues in all five of those client accounts. The remainder of the AP's client accounts had not been

transferred from the previous member and were in transit at the time of the MFDA's examination. Compliance elected not to review the AP's entire book of business to identify whether leveraging issues was a trend in all of the AP's accounts. Instead, Compliance identified those five accounts in the member's examination report and referred the issue to Enforcement, at the conclusion of the 15-week benchmark. In its examination report to the member, the MFDA did not indicate that it was referring the specific AP and issues to Enforcement. Although Compliance had shared some information about the examination with Enforcement before issuing the examination report, Enforcement did not open its case until after it issued the compliance examination report. The AP was able to transfer most of the clients over to the new dealer during the 15-week period. The MFDA did not review the former dealer for allowing the unsuitable leveraging after it identified the issue. MFDA Compliance has the scope and authority to review situations outside of its regular examination program. If a situation warrants it, COs should have the freedom to review matters related to compliance issues at members not under current examination.

Staff recommendations

ASC, MSC and SFSC staff recommend that the MFDA consider new sample size methodology and testing procedures for its program. In addition, the MFDA should provide more guidance to its staff by describing what types of situations warrant increasing sample sizes in the field.

Priority: High.

MFDA's response:

(i) The MFDA compares its examination practices to securities regulators in Canada, the United States and internationally, including our sampling methodology. Based on our information of regulators' best practices, MFDA's sampling methodology and standards meet or exceed those of other securities regulators.

The ASC, SFSC and MSC recommend that the MFDA adjust its sampling based on the population of client accounts. In a typical examination of a high risk Member with multiple branch locations, our current sampling requirements results typically in 200 – 300 total client accounts being examined. The range is determined by the extent of the Member's activities in certain high risk areas, namely leveraging and trading in exempt securities. The largest MFDA Member has over 2 million client accounts. From a statistical standpoint, the size of the population is largely irrelevant for large populations, unless the size of the sample exceeds a few percent of the total population one is examining. What is often more important than the actual size of the sample is trying to ensure that it is as representative as possible of the various types of accounts, trades, processes, etc., at the Member. In that regard, our examination program provides significant guidance to staff to ensure sampling is representative of the Member operations.

We believe our sample sizes are adequate and effective in assessing Member compliance.

If there are new sampling standards that the various CSA jurisdictions employ in their examinations, we would very much appreciate the opportunity to collaborate and discuss best practices in this area.

(ii) As noted above, we believe our minimum samples are effective in assessing Member's control processes and compliance with regulatory requirements. In the third round of examinations, we have employed higher minimum sample sizes for high risk Members to ensure our regulatory efforts are focused more on higher risk Members. Consistent with the practice of other regulators, in certain situations staff uses professional judgment to expand sample sizes. We have increased sample sizes by 200% or more during the planning of an examination where a particular issue is identified. In addition, where significant deficiencies are identified during the examination, sample sizes may be increased. This is most frequently done where we have identified trades of particular concern. For example, where frequent trades are identified in a client account, we review more (and sometimes all) accounts of the particular AP involved. We may also require that the Member, or an independent monitor, review all accounts of particular APs and report the results to the MFDA if we have identified weaknesses in the Member's supervision and numerous investment suitability or leveraging suitability issues. However, in most cases, identifying a deficiency in a sample is not, in and of itself, a reason to expand the sample. The minimum sample sizes typically provide sufficient information to assess the Member's controls and compliance with applicable requirements and determine appropriate next steps, which may include remedial action by the Member or referral to Enforcement for further detailed investigation.

The example cited by ASC staff does not relate to the MFDA failing to increase sample sizes, as we had sampled all accounts that were transferred in to the Member being examined. Rather, it suggests the MFDA should have performed an investigation into the leveraging activities of the AP at the previous Member, which was in fact performed. There is a significant difference in the compliance and enforcement functions. MFDA Compliance performs an overall assessment of a Member's controls and procedures sufficient to determine if an issue exists and, where specific concerns with respect to AP activity are identified, these matters are addressed through our Enforcement function. It would be unnecessarily duplicative for both MFDA Compliance and Enforcement to conduct such an analysis and would significantly delay the examination process to perform an investigation into every APs trading activity where an issue was identified.

As noted previously, if the CSA jurisdictions have established new standards with respect to sampling that they employ in their examinations, we would very much appreciate the opportunity to collaborate and discuss best practices in this area.

Staff comments and follow-up:

We acknowledge the MFDA's comments regarding its sample size methodology. We will continue to work on this issue with the MFDA through our ongoing oversight.

We agree with the MFDA that there is a difference in the compliance and enforcement functions; however, the difference in functions should not unnecessarily impede the MFDA's overall responsiveness when serious investor protection issues are identified through compliance activity. Compliance officers should collect all relevant and necessary information from members and APs during examinations.

Our examples cited in this section highlight the need for timely identification of issues, the importance of effective and complete information collection by the MFDA, and the necessity for appropriate MFDA responsiveness. As the MFDA noted in its response, an investigation into the previous Member was conducted; however, the issue was first identified by the MFDA during the examination in question in May 2008. The issue was reviewed by MFDA Case Assessment in March 2009, escalated to Investigations in April 2009, and closed by Investigations in April 2010 with no violations established. This is not a timely response to investor protection issues.

We will continue to monitor the MFDA's effectiveness of identifying and resolving issues through its compliance examination and enforcement referral process.

7. Review of compliance examination files

ASC staff reviewed five head office and seven branch location compliance files, MSC staff reviewed five head office and four branch location compliance files, and SFSC staff reviewed four head office and four branch location compliance files.

(a) Quality of examination reports and timeliness of examination completion

Background information

Each member examination report notifies the member of the MFDA's findings and identifies any deficiencies. The report notifies the member of what areas of the member's operations Compliance examined, the sample sizes utilized for each section of the program, the number of deficiencies Compliance identified in each sample, and what those deficiencies were.

The examination reports follow an outline prepared by MFDA staff and the MFDA employs standardized wording. Prior to issuing the report to the member, the Director of Prairie Region reviews the report as an internal quality control measure. The Director of Prairie Region then sends the report to the Director of Sales Compliance (located in Toronto) who conducts a similar quality control review for all MFDA sales compliance examination reports. The Director of Sales Compliance then sends the report back to the PrRO's Compliance group to send to the member.

ASC, MSC and SFSC staff noted that the MFDA does not undergo a similar quality control process for the responses that take place between the MFDA and the member, after the report is issued. These responses are an integral part of the examination resolution process. MFDA management indicated that a similar quality control process is not required for the responses, after the examination report, as the PrRO's staff are on-the-ground and familiar with the particulars of the examination.

Staff findings

ASC, MSC and SFSC staff found in our file review that, in some instances, the examination report did not effectively articulate the desired corrective actions required of the member. This can result in a series of back-and-forth responses between Compliance and the member wherein certain points are debated for, sometimes, up to a year and a half after the report is issued.

In our file review, ASC staff identified that the PrRO's Compliance staff were unable to close three of five¹⁵ head office examinations through its response process in a timely manner. MSC staff identified similar results in two of five head office examinations, and SFSC found similar results in one of four head office examinations.

ASC, MSC and SFSC staff found that the following issues related to the MFDA's examination report process contributed to the length of time it took for the PrRO's Compliance staff to close an examination:

1. The standardized wording of the examination reports does not, in all cases, articulate the desired corrective action the MFDA requires of the member, particularly when findings are novel. Compliance only begins to be more prescriptive to the member in the responses that follow the report, and in subsequent communication.
2. The report does not articulate what deficiencies are significant and whether the member should correct certain deficiencies as a matter of priority.

ASC, MSC and SFSC staff have considered that the MFDA released Bulletin #0355-C on January 28, 2009 wherein it described common deficiencies for its second round of examinations and the MFDA's desired corrective action for some of those specific deficiencies.

ASC, MSC and SFSC staff also found that the PrRO's Compliance Department and several Prairie regional members engaged in a series of up to 11 responses over the course of a year and a half after the MFDA issued its examination report. In some cases, the PrRO's Compliance staff closed compliance examination files not because each of the member's second round deficiencies had been corrected, but because Compliance had begun its third round of examinations. ASC, MSC and SFSC staff are concerned with the PrRO's Compliance Department engaging in these types of drawn out examinations, as it is unresponsive and unacceptable. In these cases, there was no assurance that member deficiencies had been corrected in a timely manner.

ASC, MSC and SFSC staff have taken into account that the PrRO's Compliance Department has recently amended its procedures with respect to the response portion of its examination process. The PrRO's Compliance group will now require

¹⁵ Of the other two files ASC staff tested: (i) PrRO's Compliance staff had just completed the examination and it was not in the response writing stage at the time, and (ii) the member had resigned shortly after the MFDA issued its report and did not respond to the report.

the member to meet in-person or attend teleconference meetings with the PrRO's staff, if the member does not adequately correct deficiencies in a timely manner.

Staff recommendations

The MFDA should consider the effectiveness of its examination reports. Additionally, the MFDA should comment on ways it could improve its post examination communication, to its members, to facilitate a timely and complete examination process.

Priority: High.

MFDA's response:

We note that, where ASC, MSC and SFSC staff concluded the MFDA was unable to close the file in a timely manner, almost all Members were referred to Enforcement for fundamental deficiencies in their suitability and supervision processes or for a failure to cooperate. Given the seriousness of the issues identified, it should be expected that the issues are not easily and, therefore, quickly resolved. The difficulty in resolving the issues with these files was not a function of insufficient action by MFDA staff, as noted by the number of responses. While we have taken additional measures to attempt to address issues more quickly, where resolution requires significant changes to a Member's operations or where a Member refuses to cooperate, delays are unavoidable.

We have provided more direction to Members in our examination reports and implemented additional management oversight of examination replies in order to attempt to close files faster to the greatest extent possible.

We have also issued additional bulletins to Members subsequent to the review period to assist Members in developing appropriate Policies and Procedures Manuals (#0395-C), identify Financial Compliance Common Deficiencies (#0427-C), and the Leverage Guide, Leverage Review Worksheet, & Approved Person Leveraging Analysis Template (#0431-C). We continue to work on additional guides and bulletins to assist Members in addressing compliance concerns in a timely manner.

Staff comments and follow-up:

We acknowledge that the MFDA has issued additional guidance to Members. We will continue to monitor the MFDA's progress in issuing effective compliance examination reports and resolving examinations in a timely and responsive manner through our ongoing oversight.

(b) File documentation

Background

ASC, MSC and SFSC staff reviewed the files for completeness and adequate documentation to support the outcome of each examination.

Staff findings

ASC, MSC and SFSC staff note that file documentation was, for the most part, adequate. The files staff reviewed contained a list of file contents, a completed planning section and field work section, which had evidence of review by the Manager of Compliance.

The working papers contained analyses, results and conclusions to support the procedures set out in the compliance examination program.

Staff recommendations

None.

D. Relationship between the Enforcement and the Compliance departments

1. Introduction

The MFDA's Compliance and Enforcement departments are tasked with two separate aspects of achieving investor protection and each possesses different powers, abilities, and tools as the MFDA seeks to achieve its mandates. Both departments rely on the other to carry out specific tasks that fall within the parameters of each department's purview and abilities. Because of this cooperative necessity, the MFDA has designed internal procedures that define the distinct roles of both Compliance and Enforcement within its organization. The MFDA has extensively developed these procedures and this cooperative relationship between the two departments during the Review Period.

2. Purpose and scope

ASC, MSC and SFSC staff reviewed MFDA procedures and interviewed MFDA staff to better understand the organization's day-to-day functions that necessitate the cooperation between the departments.

3. Referral process

Background information

The MFDA has created internal procedures that define many aspects of the relationship between the two departments. The existing procedures define the types of issues that are to be referred from Compliance to Enforcement. The procedures categorize referrals into levels based on the seriousness of issues.

The procedures also describe what duties each department has the ability to perform and what information staff in both departments are able to share when a file has been referred. MFDA staff in these departments have the ability to communicate and consult each other during the course of examinations or investigations.

Staff findings

ASC, MSC and SFSC staff are concerned that the MFDA's processes restrict its ability to be responsive in certain circumstances. The definitions and thresholds, that the MFDA has created and uses to determine what is to be referred from Compliance to Enforcement, create a large distinction between the two departments and their respective power to address regulatory concerns. ASC, MSC and SFSC staff noted in our review of compliance examination files, that issues identified by the PrRO's Compliance that were referred to Enforcement were, generally, not issues that were concluded in litigation, settlement agreements, or other formal enforcement action. Those files often concluded with Enforcement issuing a warning letter to the member or entering into an A&U with the MFDA. MFDA Compliance then oversees the corrective action the member agreed to with Enforcement. ASC, MSC and SFSC staff's main concerns are these:

1. The processes hinder Compliance's ability to be flexible and timely.

2. The processes and procedures eliminate many opportunities where Compliance might otherwise interact with members to identify instances of non-compliance and work with the members to ensure they immediately correct non-compliant behaviours.
3. The processes establish a more confrontational and collection-of-evidence based approach through Enforcement interaction with the member than what may be achieved through Compliance. If the MFDA's objective is to have the member comply and correct its deficiencies and not have the file result in litigation, then choosing the more responsive and timely approach would seem more appropriate.
4. The processes require Enforcement to establish breaches based on a standard of proof to achieve a successful prosecution. This requires a more comprehensive review and greater evidentiary hurdles than a compliance examination, and tends to delay the overall MFDA response. As noted above, most files reviewed by ASC, MSC and SFSC staff did not conclude in litigation.

ASC, MSC and SFSC staff understand that it is appropriate and necessary that the MFDA escalate some specific issues to Enforcement; however, Compliance should have the appropriate tools and ability to ensure timely and ongoing compliance with rules and regulations.

Staff recommendations

ASC, MSC and SFSC staff recommend that the MFDA review its Compliance procedures and referral processes and consider what changes it could make in the PrRO to be more responsive to instances of non-compliance by its members.

Priority: High.

MFDA's response:

The Enforcement/Compliance referral process enhances Compliance's ability to be flexible and timely and does not restrict opportunities to work with Members to ensure they resolve deficiencies. Where issues are referred to Enforcement, Compliance continues to work with and correspond with the Member to try to resolve the deficiencies while the matter is being reviewed or investigated by Enforcement. In many cases, issues are referred to Enforcement due to their seriousness and the expectation that Compliance processes and follow-up may be insufficient to address the issues. This may be because the Member has been unwilling to address the issues or that it lacks the resources and expertise to address the issues and it is felt that an independent consultant may be required to assist the Member. However, this does not mean that Compliance does not still attempt to resolve the issues with the Member as quickly as possible in the interim while enforcement action is being taken.

In our experience, we have not found that referring matters to Enforcement creates a more confrontational approach. In fact, we find that referring serious deficiencies to Enforcement results in Members recognizing the seriousness of the issues and becoming more motivated and committed to addressing the deficiencies.

In our view as a regulator with an investor protection mandate, all serious matters should be referred to Enforcement. There is a benefit to creating a disciplinary record for Members with serious deficiencies. Informal discipline, through warning letters and A&Us, has a significant specific deterrent and remedial effect and often results in improved compliance. While no referrals resulted in formal enforcement proceedings in the Prairie Region during the review period, other referrals did result in formal proceedings in other Regions. Compliance referrals have continued to result in effective formal and informal discipline since the review period.

Staff comments and follow-up:

While we agree that many issues that were referred to Enforcement were referred by Compliance due to their seriousness, the ineffectiveness of some of the MFDA's Compliance processes is still a concern. We will continue to work with the MFDA to ensure its compliance processes are effective and address issues in a responsive manner.

4. Timing of referrals to Enforcement

Background information

Compliance issues examination reports to the members at the conclusion of each review. In the examination report, Compliance formally notifies the member of any issues that it has referred to Enforcement at the same time. Compliance then sends a formal referral memo to Enforcement that usually coincides with the issuance of the examination report to the member. Enforcement then formally opens a case and begins its review of the referred issues.

The MFDA's procedures indicate that referrals may be made either before or after Compliance has completed its review of the issues. However, the procedures also indicate, on several occasions, that Compliance's referral memo should be sent to Enforcement accompanied by the examination report.

Staff findings

ASC and MSC staff found that the PrRO's Compliance staff did not refer significant issues, such as suitability of leveraging, non-operational back-office systems, and a member being unable to detect churning, to Enforcement until close to the end of its benchmark of 15 weeks.

The MFDA's operating procedures described above do not encourage timely and responsive action to significant investor protection issues such as critical member compliance failures. The PrRO's Compliance staff identified these issues early on in the examination process, and in some cases, on the first day of fieldwork. In these instances, the compliance deficiencies were subject to two reviews and two sets of benchmarks: Compliance's review completed in 15 weeks and then Case Assessment's review that was to be concluded within a further 120 days.

Although MFDA staff informed us that Compliance and Enforcement are in constant contact about the issues at the time Compliance identifies them, ASC, MSC and SFSC staff are still concerned that Compliance sends the formal referral to Enforcement at the

time when the examination report is sent to the member, and not when it first identifies the issue(s). Enforcement does not open a case and begins working on the issues until it receives this formal referral. This delay is unacceptable.

Staff recommendations

The MFDA should reconsider its current procedures and decrease the time that elapses between Compliance identifying the referable issues and making the formal referral to Enforcement.

Priority: High.

MFDA's response:

The Compliance/Enforcement Referral procedures require that certain matters be referred immediately when identified. Issues relating to extremely serious conduct, such as fraud and theft, as well as serious capital concerns or a Member's refusal to cooperate are referred immediately. Other matters are typically referred when the examination report is issued as, at this time, all information has been collected and thoroughly analyzed, the analysis and findings have been subject to management review to ensure the accuracy of the findings and the Member has had an opportunity to comment on the findings both during the examination and more formally at the exit meeting. Since Compliance has completed this level of detailed review and analysis, Compliance referrals, particularly those related to account supervision, are typically not subject to the 120-day Case Assessment benchmark but rather are fast-tracked and immediately escalated to Investigations.

We believe that it is ineffective to refer specific matters to Enforcement on a piecemeal basis as they arise during the course of a compliance examination, as other related or serious matters may be identified later in the examination that Enforcement will need to consider. In addition, it should be noted that Enforcement staff reviews not only the compliance examination report but also the Member's response to the issue prior to determining how the case should be handled.

Staff comments and follow-up:

We acknowledge the MFDA's response. We note that the MFDA communicates the need for compliance to collect and thoroughly analyze issues that have been identified during the examination. These comments emphasize the importance of collecting complete information prior to making a referral to Enforcement. This relates to our finding and follow-up comments in the Compliance section of the Prairie Regional Office Report above, under the headings, *Compliance examination program 6.(b).(ii), Increasing sample sizes in the field.*

We will continue to work with the MFDA's PrRO to ensure it performs timely and responsive referrals to Enforcement when appropriate.

5. Use of A&Us and Independent Consultants (IC)

Background information

Following a compliance examination, Compliance will refer significant issues and member violations to Enforcement. Enforcement then conducts its review of the case and makes a recommendation. In some files of this nature, MFDA Enforcement has recommended that the member sign an A&U with the MFDA. The member must abide by the T&Cs set out in the A&U (terms and conditions may vary depending on the situation and by member). After the member agrees to the A&U, MFDA Enforcement refers the case back to Compliance whereby Compliance becomes responsible for the oversight of the member's adherence to the A&U.

A common condition included by the MFDA in A&Us has been a requirement that the member appoints or hires a third-party monitor or IC to oversee the member's compliance action plan and ensure that it correct its deficiencies identified in the examination. In these situations, members have generally appointed a professional accounting firm as the IC. The IC sometimes creates an action plan and new processes that the member must implement and adhere to. In other cases, the member has been responsible for creating this action plan and implementing the new processes. In either scenario, the IC is then required to perform a review of the member, test whether it was successful in implementing the action plan and processes, and notify the MFDA of whether the member satisfactorily corrected its deficiencies.

Staff findings

ASC and MSC staff found that, during the Review Period, the MFDA's use of A&Us in the Prairie region have been unsuccessful in achieving member compliance. In one of two situations during the Review Period where the MFDA used A&Us for Prairie region members, the A&U process failed for various reasons. Both A&Us may have also served to lengthen the period of time that the members operate in a non-compliant state. Based on these findings, ASC, MSC and SFSC staff question the execution of the A&U process for members in the Prairie region.

Staff have two main concerns when considering the MFDA's effectiveness at changing member behaviour through the use of A&Us and ICs:

1. Responsiveness

In examples identified in the Prairie region, Compliance first identified serious issues during the examination process more than two years before the conclusion of the A&U and IC process.

2. Effectiveness

In one of two Prairie region files where the member agreed to the A&U and IC, the member failed the testing carried out by the IC and the member was referred back to Enforcement for breaching the terms of its A&U. ASC staff's review of the file revealed that the use of an IC was ineffective at ensuring the member corrected its deficiencies.

MFDA staff indicated during the oversight review that the MFDA is currently considering and developing alternatives to using ICs. In further discussions, MFDA staff also indicated that they may continue to use A&Us and ICs to promote member compliance in certain situations; one change is that the IC will help the member implement the corrective action plan, rather than only creating and testing the plan. Consequently, the IC will be involved in the entire corrective process.

Staff recommendations

ASC, MSC and SFSC staff recommend that the MFDA consider what changes it could make to the A&U and IC process to ensure that it takes the issues of responsiveness and effectiveness into account.

Priority: High.

MFDA's response:

The use of monitors and independent expert consultants is a proven method of addressing non-compliance that has been used effectively by many securities regulators. The MFDA has implemented these requirements nationally in both formal hearings and informal A&Us on a number of occasions. Many Members have made substantial improvements in their compliance structure and procedures as a direct result of these processes. This has resulted in a number of Members significantly increasing the number of compliance staff they employ, investing in new systems to provide significantly enhanced compliance tools and reporting and developing far more robust compliance structures and supervisory procedures. These improvements have been well beyond what we believe the Members could have achieved without the involvement of consultants. While A&Us do not always result in all deficiencies being satisfactorily resolved, neither do other measures including normal compliance processes or formal discipline.

In the infrequent cases where the Member failed subsequent testing by the consultant, this has related to the level of the Member's willingness and ability to implement the improvements identified by the consultant, and not to any flaw in the process. In these cases, we have proceeded to formal discipline.

We are continually looking to improve all of our processes. The A&U process is an example where we have constantly refined and improved the process to try to better achieve the objective of adequate resolution of identified compliance deficiencies. There are steps we have taken and can take to continue to achieve this objective, such as streamlining our procedures to implement A&Us more quickly and having the consultant involved in the entire corrective process, including the implementation of the action plan. We are still of the view that A&Us can achieve an effective remedial solution and do so more quickly than through formal proceedings, and we believe that they should continue to be one of the tools that we use where formal proceedings are not warranted. Nevertheless, ultimate resolution of deficiencies is the responsibility of the Member, and there may be, in future, other situations where the first regulatory intervention may not achieve full compliance. The MFDA, like other regulators, will monitor such situations

and, where deficiencies are not remedied, take escalated action in those circumstances to enforce compliance with its requirements.

Staff comments and follow-up:

ASC, MSC and SFSC staff are satisfied with the MFDA's response and will continue to monitor its use of monitors and independent consultants to ensure member compliance.