



**AUTORITÉ  
DES MARCHÉS  
FINANCIERS**

# **CONSULTATION ON THE REGULATORY FRAMEWORK APPLICABLE TO THE MUTUAL FUND SECTOR**

## **FURTHER TO THE REGISTRATION REFORM PROJECT**

**February 20, 2007**

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## **1. PURPOSE OF CONSULTATION**

Part of the mission of the *Autorité des marchés financiers* (“AMF”) is to provide assistance to consumers of financial products and supervise the activities connected with the distribution of these products.

To help fulfill its mission, the AMF is conducting a consultation with mutual fund firms (known as group savings plan firms), their representatives and a number of stakeholders from the industry concerning the impacts resulting from a reform of the registration regime (“reform”) as proposed under draft *Regulation 31-103 respecting registration requirements* (“Regulation 31-103”) published for comment on February 20, 2007. Regulation 31-103 and related documents are available on the AMF website at <http://www.lautorite.qc.ca/projets-speciaux/reforme-inscription.fr.html>.

This consultation is primarily geared toward certain legislative and regulatory impacts of reform on mutual fund firms and representatives, in particular recognition by the AMF of an industry self-regulatory organization.

Further to this consultation, the AMF will review the comments and propose measures to the ministère des Finances du Québec in order to ensure a harmonized and equitable regulatory framework for the mutual fund distribution sector, as well as appropriate transition periods.

## **2. BACKGROUND AND OBJECTIVES OF REFORM**

As part of its participation in the work carried out by the Canadian Securities Administrators (“CSA”), the AMF’s objective is to modernize the current registration regime applicable to securities intermediaries and thereby help meet the need for harmonization and simplification.

As a result of reform, registration categories and conditions would be harmonized across Canada, with a revision of the National Registration Database (NRD). In particular, solvency and proficiency requirements will be identical and would therefore be applied consistently to all persons registered in a given category, regardless of the jurisdiction where their activities are carried on.

This harmonization, modernization and simplification of the registration regime forms part of the framework of the passport registration system that is scheduled for implementation in 2008 concomitant with the coming into force of Regulation 31-103.

## **3. NEW FEATURES FOR THE MUTUAL FUND DISTRIBUTION SECTOR**

Reform would have major impacts on the mutual fund distribution sector in Québec. The AMF believes that the regulatory framework applicable to this sector in Québec should be identical to that in effect in the other Canadian jurisdictions following reform.

Impacts would include:

- a. Mutual fund firms (group savings plan firms) and their representatives, which are currently governed by the *Act respecting the distribution of financial products and services* (“Distribution Act”), would now be governed by the *Securities Act* (“SA”);
- b. With respect to net free capital and financial institution insurance requirements, mutual fund firms, which would become mutual fund dealers, would be subject to the rules of the Mutual Fund Dealers Association of Canada (“MFDA”), just like mutual fund dealers outside Québec; they would also be required to file the MFDA *Financial*

*Questionnaire and Report*<sup>1</sup> in its entirety.

The AMF submits the following elements for discussion:

1. Mutual fund firms in Québec should join a self-regulatory organization (“SRO”) that is specialized in the sector (an “industry SRO”);
2. The second paragraph, section 149 of SA,<sup>2</sup> which restricts a representative of a dealer with an unrestricted practice from concurrently carrying on business as such and being employed by a financial institution, unless the representative is specialized in group savings or scholarship plans, should be repealed.

#### **4. CURRENT SUPERVISION OF MUTUAL FUND SECTOR IN QUÉBEC**

The current regime in Québec governing mutual fund firms and their representatives differs markedly from the regime in force in other Canadian jurisdictions.

##### **4.1 Mutual fund firms**

Mutual fund firms are governed by the Distribution Act, which sets out a supervisory regime that is different from that under SA.

In particular, mutual fund firms are not:

- subject to a permanent registration system identical to that set out under SA and the *Securities Regulation* (“SR”), to which securities dealers and advisers are subject;
- required to join the MFDA or any other SRO;
- required to maintain a financial institution insurance policy or bond, but instead must maintain liability insurance for errors and omissions;
- required to maintain and calculate their regulatory capital (net free capital) according to the standards currently in effect in other jurisdictions.

The AMF believes that these specific requirements cannot form part of a passport registration system and should therefore no longer be maintained. It therefore proposes that mutual fund firms and their representatives be governed by a harmonized national regime.

##### **4.2 Mutual fund representatives**

Mutual fund representatives:

- are required, under section 312 of the Distribution Act, to be members of the *Chambre de la sécurité financière* (“CSF”) and to pay the annual contribution determined by CSF regulation (section 320 of the Distribution Act), subject to suspension of their certificate for failure to do so (section 320.3 of the Distribution Act);
- are subject to the jurisdiction of the CSF discipline committee which, under section 354 of the Distribution Act, “shall decide all complaints filed against representatives in insurance of persons, group insurance representatives, securities representatives

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<sup>1</sup> <http://mfda.ca/regulation/forms.html>

<sup>2</sup> The restriction under section 149 of SA reads as follows: “Subject to such remunerated business as may be carried on under a government regulation made under this Act, the representative of a dealer acting as principal or as agent shall not concurrently carry on business as such and be employed by a financial institution, unless he is a representative specialized in group savings or scholarship plans.”

and financial planners”;

- may be employed by a financial institution, because the restriction set out in the second paragraph, section 149 of SA applies solely to representatives of a dealer acting as principal.

### Question 1

Are there any disparities in the structures and operations of Québec-based markets, particularly with respect to the distribution methods for mutual fund securities, that could account for a distinction in regulatory requirements when compared with requirements in other jurisdictions?

### 4.3 Financial services compensation fund

Established pursuant to section 258 of the Distribution Act, the *Fonds d'indemnisation des services financiers* (financial services compensation fund) enables the AMF to pay indemnities to victims of fraud, fraudulent tactics (dishonest operations) or embezzlement as a result of dealings with individuals and firms authorized to operate under the Distribution Act.<sup>3</sup>

However, the fund does not cover cases in the event of insolvency unrelated to fraud.

The fund is made up of the annual dues that firms and representatives registered with the AMF under the Distribution Act are required to pay.

The AMF is not recommending any changes to the requirement that mutual fund firms and their representatives contribute to the financial services compensation fund. Nonetheless, the AMF seeks to ensure an equitable regulatory framework in this regard and is mindful that recognition of the MFDA as an industry SRO in Québec, as outlined in section 6 of this document, could give rise to dual contributions in respect of two compensation funds providing different coverage.

Indeed, the MFDA requires that members pay annual fees to the Investor Protection Corporation which, unlike the financial services compensation fund, covers only cases involving the insolvency of firms.

The AMF would therefore ensure that dues payable to the financial services compensation fund are taken into account in light of any contributions that Québec firms may be required to pay, as the case may be, to the Investor Protection Corporation in order not to increase the regulatory burden of these firms.

## 5. PROPOSED SUPERVISION OF MUTUAL FUND SECTOR IN QUÉBEC

### 5.1 Transition to Securities Act (“SA”)

#### New regime

Among proposed legislative amendments in support of reform, the Distribution Act would be amended so that the activities of mutual fund firms and their representatives<sup>4</sup> would be

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<sup>3</sup> The AMF may also rule on the admissibility of claims under the *Regulation respecting the eligibility of a claim submitted to the Fonds d'indemnisation des services financiers* and decide the amount of the indemnities to be paid. Indemnities paid out of the compensation fund may total up to \$200,000 per claim.

<sup>4</sup> The AMF also recommends that investment contract brokerage and scholarship plan brokerage activities be governed by SA.

governed by SA and Regulation 31-103.

The AMF proposes this legislative amendment for the following reasons:

- a. The AMF seeks to achieve greater equality of treatment in situations that are virtually similar and for which disparities in the treatment of registration categories do not seem justified;
- b. Current disparities in the treatment of mutual fund firms and dealers governed by SA compared with the treatment of mutual fund firms and persons registered in the sector in other jurisdictions present an obstacle to harmonization and the efficient operation of a passport registration system;
- c. Regulatory inconsistencies such as insurance and net free capital requirements for registrants as well as financial statement filings with the AMF complicates the framework for the distribution of securities in Québec.

Impact on registration fees payable and the maintenance of registration

Transitioning to a regime governed by SA would result in an increase in fees payable for registrations as well as for the annual maintenance of registrations.

The fees payable for a firm’s registration and the annual fees required for registration maintenance are currently \$80 for each representative. The fees payable by a representative for the issuance of a certificate and the fees payable annually for its renewal are \$80.<sup>5</sup>

The fees payable under SR are substantially higher: Registration fees<sup>6</sup> total \$1,500 for a dealer and \$375 for each representative. The fees payable for maintaining a registration total \$1,500 for a dealer, who is also required to pay \$75 for each establishment in Québec, and the fees payable for maintaining a representative’s registration total \$375.

In summary:

	<b>Firm/dealer</b>	<b>Representative</b>
<b>Distribution Act</b>	Registration: \$80 for each representative  Maintaining registration: \$80 for each representative	Certificate: \$80  Renewal of certificate: \$80
<b>Securities Act</b>	Registration: \$1,500  Maintaining registration: <ul style="list-style-type: none"> <li>▪ \$1,500; and</li> <li>▪ \$75 for each establishment</li> </ul>	Registration: \$375  Maintaining registration: \$375

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<sup>5</sup> Fees payable under the Distribution Act are determined by the *Regulation respecting the dues, contributions and fees payable*; they are adjusted annually pursuant to section 23 of the Regulation.

<sup>6</sup> Fees payable under SA are determined in subparagraph 1, section 271.5 of SR.

## Question 2

A transition period must be determined the transition of mutual fund firms and representatives under SA. What would be an appropriate transition period under the circumstances?

## 5.2 Regulatory capital

### Background

Solvency of registered firms is ensured through compliance with the requirements related to regulatory capital (“net free capital” in Québec). The regulatory capital amount that mutual fund firms are required to maintain in Québec is currently equal to the sum obtained by adding \$50,000 to the deductible applicable to the firm’s liability insurance policy. The formula for calculating capital is set out in the Appendix to the *Regulation respecting the trust accounts and financial resources of securities firms*.

### New regime

Regulation 31-103 provides for a uniform regime under which registrants who are SRO members must calculate regulatory capital according to the requirements of the SRO, while registrants who are not SRO members<sup>7</sup> must maintain and calculate regulatory capital according to the provisions and formula set out in Regulation 31-103.

Mutual fund firms registered outside Québec will still be required to maintain and calculate regulatory capital according to MFDA rules (“risk adjusted capital”) and, more particularly, to file the MFDA’s *Financial Questionnaire and Report* (“FQR”).<sup>8</sup>

Québec mutual fund dealers would also be subject to MFDA’s capital requirements and required to file FQR in its entirety with the industry SRO.

The requirements are as follows:

- \$50,000 for a firm that does not hold client cash, securities or other property;
- \$75,000 for a firm that does not hold client securities or other property, except client cash in a trust account;
- \$200,000 for any other registered firm.<sup>9</sup>

## Question 3

Would mutual fund firms be able to comply with this new requirement? If not, explain why and indicate an appropriate transition period under the circumstances.

<sup>7</sup> Firms that are not SRO members would be portfolio managers and exempt market dealers.

<sup>8</sup> <http://mfda.ca/regulation/forms.html>

<sup>9</sup> The insurance deductible is taken into account in each of these amounts.

## 5.3 Insurance

### Background

The requirement whereby mutual fund firms and their representatives must hold liability insurance is intended to protect them against errors and omissions.

The requirement for firms is set out under section 29 of the *Regulation respecting firms, independent representatives and independent partnerships*. A firm's liability insurance coverage may not be less than \$500,000 per claim and, for each 12-month period, not less than \$1,000,000 for a firm with three representatives or fewer (\$2,000,000 for a firm with more than three representatives).

As for representatives, they are required, under the *Regulation respecting the pursuit of activities as a representative*, to hold liability insurance coverage that may not be less than \$500,000 per claim and \$1,000,000 per year.

On the other hand, Québec securities dealers have been required, since 1983, to maintain financial institution insurance, or a financial institution bond, under section 213 of SR. This is intended in particular to provide coverage against dishonest conduct or fraud by representatives as well as against loss of securities and forgery. This insurance regime applies to registrants in all jurisdictions.<sup>10</sup>

### New regime

The AMF recommends that mutual fund dealers in Québec be required, as they are across Canada, to subscribe for financial institution insurance for coverage against dishonest conduct or fraud by representatives as well as against loss of securities and forgery. On the basis of insurance regimes applicable internationally, the AMF believes that the financial institution insurance would constitute a more suitable means of coverage in the circumstances.

The AMF proposes the application of requirements set out under MFDA rules whereby the minimum amount of insurance to be maintained must be the greater of:

- a. \$50,000 for each representative up to a maximum of \$200,000,<sup>11</sup>
- b. 1% of the base amount (i.e. the greater of: a) the net value of cash and securities held by the firm on behalf of clients; and b) the total allowable assets of the firm determined in accordance with Statement A of MFDA's Form 1).

### **Question 4**

Do you agree with this proposal? If you disagree, please explain.

## 5.4 Repeal of second paragraph, section 149 of SA

The AMF is considering the repeal of the second paragraph, section 149 of SA and solicits comments in this respect. In Québec, only mutual fund and scholarship plan representatives governed by the Distribution Act may also be employed by a financial institution. This option is not available to representatives of a dealer with an unrestricted practice governed by SA.

<sup>10</sup> For details of insurance coverage, see Appendix A to draft Regulation 31-103.

<sup>11</sup> The amount is \$500,000 for a registered firm that holds client property (securities or cash) and is therefore referred to as a "Level 4" according to MFDA rules.



The AMF believes that being concurrently employed by a financial institution is a matter related to the control and monitoring carried out by the AMF at the time of the representative's registration. If potential conflicts of interest arising from the relationship between the dealer to which the representative is attached and the financial institution related to the dealer are properly managed, this activity should not be permitted for one category of representatives and denied to another.

The restriction set out in the second paragraph, section 149 of SA does not exist in other jurisdictions..

#### **Question 5**

Do you agree with such a proposal? If you disagree, please explain.

#### **Question 6**

If the second paragraph, section 149 of SA were to be repealed, how would this impact your distribution activities and structures?

## **6. AMF RECOGNITION OF INDUSTRY SRO**

### **6.1 Introduction**

The AMF believes the mutual fund sector must have an industry SRO for the purpose of supervising firms in accordance with Regulation 31-103.

SRO oversight is a specialized activity in a given sector, thereby enhancing the supervision of participants and improving investor protection.

Recognition of an industry SRO would take place pursuant to section 59 of the *Act respecting the Autorité des marchés financiers* ("AMF Act").

### **6.2 Status quo**

The AMF has given consideration to the status quo, namely, maintaining the requirement for mutual fund representatives to join the CSF, without recognition in Québec of an industry SRO for firms. It has concluded that other options may be more appropriate.

### **6.3 Options**

The AMF has identified three options regarding the recognition of an industry SRO:

1. recognition of the MFDA with exclusive jurisdiction over mutual fund firms and representatives in Québec;
2. recognition of the MFDA with exclusive jurisdiction over firms and representatives but with CSF outsourcing of functions related to representatives;
3. recognition of the CSF as industry SRO and adoption by the CSF of all MFDA rules.

#### **6.4 Industry SRO membership fees and annual fees**

The MFDA membership fee is based on the level of the mutual fund dealer and varies from \$3,000 to \$5,000. Annual membership fees are set, for the period from July 1, 2006 to July 1, 2007, at the following amounts:

- \$102 per million on the first \$500 million of assets under administration;
- \$96 per million on the next \$500 million of assets under administration;
- \$88 per million on the next \$4 billion of assets under administration;
- \$82 per million on the next \$5 billion of assets under administration;
- \$77 per million in excess of \$10 billion of assets under administration.

In the event the CSF is recognized as an industry SRO in Québec, fees payable to the CSF would be identical to fees payable to the MFDA. This hypothesis is retained since the responsibilities of CSF would be identical to the ones assumed by the MFDA in other provinces.

The appropriateness of each of the three foregoing options, which are described in more detail as follows, must be considered based on the hypothesis that membership and annual fees would be identical, irrespective of which option will be proposed to the ministère des Finances du Québec.

#### **6.5 Option 1: recognition of MFDA in Québec**

This option recognizes the MFDA as an industry SRO in Québec with exclusive jurisdiction over mutual fund firms and representatives. Under this option, the CSF would have no jurisdiction over mutual fund representatives. Under this option:

1. the registration of mutual fund dealers and their representatives would not be delegated to the MFDA and the function would continue to be performed by the AMF;
2. the inspection of mutual fund dealers would be delegated to the MFDA;
3. mutual fund dealers would be subject to the early warning system regarding regulatory capital as well as all MFDA rules;
4. the MFDA would perform all functions in respect of mutual fund representatives and this would:
  - eliminate the role of the CSF in respect of mutual fund representatives in Québec, thereby complicating the application of the multisector principle for representatives in Québec;
  - require an amendment to the *Regulation governing compulsory professional development*, which would no longer apply to mutual fund representatives in Québec.

**Question 7**

Do you agree with this proposal? If you disagree (excluding the matter of MFDA membership fees and annual fees), please explain.

**Question 8**

Other than those discussed in paragraphs 1 to 4 above, should the recognition decision contain terms and conditions?

**Question 9**

What would be an appropriate transition period under the circumstances?

**6.6 Option 2: recognition of MFDA in Québec with CSF outsourcing**

Under this option:

1. the registration of mutual fund dealers and their representatives would not be delegated to the MFDA and the function would continue to be performed by the AMF;
2. the inspection of mutual fund dealers would be delegated to the MFDA;
3. mutual fund dealers would be subject to the early warning system regarding regulatory capital as well as all MFDA rules;
4. MFDA functions in respect of mutual fund representatives would be performed in Québec by the CSF under outsourcing terms set out in the recognition decision;
5. with respect to the conduct of representatives, shared jurisdiction between the MFDA and the CSF would be based on the representative's province of residence or business location.

**Question 10**

Do you agree with this proposal? If you disagree (excluding the matter of MFDA membership fees and annual fees), please explain.

**Question 11**

Other than those discussed in paragraphs 1 to 5 above, should the recognition decision contain terms and conditions?

**Question 12**

What would be an appropriate transition period under the circumstances?

**6.7 Option 3: recognition of CSF as industry SRO in Québec**

Under the framework model proposed by the CSF, the information available to the AMF is as follows:

1. registration of mutual fund dealers and their representatives would not be delegated to the CSF and the function would continue to be performed by the AMF;
2. inspection of mutual fund dealers with a head office in Québec would be delegated to the CSF;
3. all mutual fund dealers, regardless of where their head office is located, would

be required to join the CSF if they carry on activities in Québec;

4. mutual fund dealers with operations in Québec and outside Québec would be required to join the MFDA and the CSF;

5. Québec mutual fund dealers would be subject to all MFDA rules, including with respect to the early warning system;

6. CSF's organization, mission and powers would be harmonized with those of the MFDA, and this would require substantial amendments to the Distribution Act.

**Question 13**

What are the benefits and inconveniences of recognizing the CSF as an industry SRO for the mutual fund sector, taking into account the fact that membership fees and annual fees would be the same as those prescribed by the MFDA?

**Question 14**

What would be an appropriate transition period under the circumstances?