

**CANADIAN SECURITIES ADMINISTRATORS' STAFF NOTICE 33-303,  
81-304 TRUST ACCOUNTS FOR MUTUAL FUND SECURITIES**

***Purpose***

The purpose of this notice is to communicate the views of staff of each of the Canadian Securities Administrators on compliance with section 12 of National Policy Statement No. 39 ("NP 39"), which deals with commingling of money, by mutual fund dealers and securities dealers (collectively the "dealers"). In conducting compliance field reviews, staff have noted certain inappropriate practices related to the use of trust accounts. This notice is intended to assist dealers in complying with section 12 of NP 39 and to set out staff's views on the minimum internal controls appropriate to ensure dealers meet these requirements.

Section 12 of NP 39 sets out requirements for the proper handling of client money during the period the dealer holds such money pending either investment in mutual funds or, in the case of proceeds of redemption, delivery to the client (the "holding period"). An integral part of section 12 is the requirement that dealers maintain a trust account. The primary function of this trust account is to segregate money owned by clients relating to mutual fund purchases and redemptions from the dealer's own assets and other business activities. Segregation safeguards client assets by reducing the opportunity for loss to the investor during the holding period.

The revised versions of proposed National Instrument 81-102 Mutual Funds and proposed Companion Policy 81-102CP, which are expected to replace NP 39 and which were published for comment on March 19, 1999, incorporate the position of staff set out below.

***Designating a Trust Account***

Section 12 of NP 39 requires that dealers maintain interest-bearing trust accounts. NP 39 does not define the term "trust account" nor does it describe how such an account is to be established or maintained. Dealers have indicated that some financial institutions are reluctant to provide trust account services and hesitate to label and administer accounts opened to hold client funds as trust accounts. Staff are of the view that dealers are responsible for ensuring that client funds retain their character as trust funds while on deposit with financial institutions.

At the time of opening a trust account, a dealer should advise the financial institution in writing that the account is established for the purpose of holding client funds in trust and that the account should be labelled as a "trust account". The dealer should also advise the financial institution in writing at the time of opening the trust account that the money in the account is not to be withdrawn, including by means of electronic transfer, by any person other than authorized employees of the dealer and that the money in the trust account may not be used to cover shortfalls in any other accounts of the dealer.

***Commingling of Funds***

Section 12 of NP 39 requires that a dealer separately account for money received for the purchase or the redemption of mutual fund securities. The dealer shall not commingle such money with other assets of the dealer or with money held in trust for the purchase or the sale of

other types of securities. The dealer must maintain separate accounts, which may also be designated as trust accounts, for clearing trades in other types of securities. In the past, staff compliance examinations have revealed that some dealers have commingled money relating to mutual funds with money relating to other securities, such as guaranteed investment certificates, treasury bills and segregated funds. This practice is contrary to the requirements of section 12.

Dealers should have appropriate internal controls in place to ensure that client money related to mutual fund purchases or redemptions continues to be separately accounted for, segregated from other business transactions and held in trust. These controls should include identifying the bank account in the general ledger of the dealer as a trust account for mutual fund clients so that employees and management who have authority to direct cash transactions are aware of the purpose of this money. The dealer should maintain adequate staff to process purchase and redemption cheques and should ensure that its staff are properly trained. Staff are of the view that good internal controls will minimize errors and commingling of funds.

#### ***Allowable Expenses against Trust Account Interest***

Section 12 of NP 39 states that dealers should not use any money received for investment in mutual funds to finance their own operations. Costs associated with client cheques that are returned due to insufficient funds to cover a trade (i.e. NSF cheques) should be borne by the dealer and should not be offset by interest income earned in trust accounts. Staff are of the view that it is inconsistent with the nature of a trust account for service charges or any other fees or expenses to be paid out of funds held in a dealer's trust account.

#### ***Advancing Funds to Clients***

Staff have identified instances where dealers have advanced funds to clients to cover trades until cash is received. This type of "bridge financing" exposes the registrant to added business risk that may not be contemplated in the dealer's calculation of its required capital. If a dealer follows the practice of advancing funds to clients, it should adjust its capital calculation on a regular basis by implementing the cash account rule used by the self-regulatory organizations. In no circumstances should such funds be paid out of a trust account maintained pursuant to section 12 of NP39. Dealers should report to staff and remedy any capital deficiencies immediately.

Staff have also identified the practice of "lapping" as a form of bridge financing. Lapping occurs as a result of the timing between the trade date and the settlement date. Client funds held for unsettled trades are used to settle other client trades that do not have adequate funds to cover such trades. Staff consider this practice by dealers to be an inappropriate use of client trust funds and the practice, if followed, should be discontinued immediately.

#### ***Reconciliations and Internal Controls***

All dealers participating in the distribution of securities of a mutual fund have a duty to investors to ensure that money has been invested appropriately and on a timely basis. The dealer must ensure that it is adequately organized and that there are adequate facilities and procedures to fulfill this obligation.

Ensuring appropriate and timely investing of money is most effectively done by reconciling the trust account to the trading and accounting records of the dealer on a timely basis. Reconciliation

will ensure completeness and accuracy of all cash transactions when compared to trading and accounting records. Reconciliations should be performed at least monthly. Where the volume of transactions is large, it may be appropriate to perform reconciliations more frequently, such as weekly or daily.

It is important that dealers review reconciliations and clear reconciling items on a timely basis. This review ensures accuracy of cash transactions and acts as an additional control over the trust account. Dealers should also ensure that there is adequate segregation of the accounting, cash and review functions for the trust account(s) in order to ensure that internal controls are effective.

Securities legislation requires that dealers maintain adequate books and records necessary to record properly their business transactions and financial affairs. Reconciliations and supporting documents that evidence review and clearing of items are an integral part of a dealer's business records.

### ***Requirements in British Columbia***

Certain of the requirements of NP 39 set out above are also imposed on dealers under British Columbia securities legislation. Section 57(2) of the British Columbia Securities Rules (the "Rules") requires dealers to deposit clients' free credit balances into a trust account immediately upon their receipt by the dealer. Any interest earned on these funds must accrue to the credit of clients.

Section 58 of the Rules requires that any subscriptions or prepayments held by dealers for clients pending investment must be held in a trust account for clients separate from the trust account referred to above and must be segregated from the dealer's own assets. Any interest earned on these subscriptions or prepayments must accrue or be paid to the credit of the clients or, at the option of the dealer, the mutual fund (where these subscriptions or prepayments relate to the purchase of mutual fund securities).

Proposed amendments to the Rules, which were published for comment in the British Columbia Securities Commission's Weekly Summary on March 19, 1999, clarify that certain requirements set out in sections 57 and 58 of the Rules do not apply if a registrant is a member of certain self regulatory organizations or if a registrant complies with the trust account provisions set out in proposed National Instrument 81-102.

### ***Questions***

Please direct any questions to:

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