

ALBERTA SECURITIES COMMISSION
2004 Oversight Audit of the
Mutual Fund Dealers Association of Canada
Prairie Regional Office

EXECUTIVE SUMMARY

The Alberta Securities Commission (“ASC”) recognized the Mutual Fund Dealers Association of Canada (“MFDA”) as a self-regulatory organization on April 10, 2001. Between February 2, 2004 and February 9, 2004, ASC Staff conducted an oversight audit of the Compliance and Membership Departments at the Prairie Regional Office of the MFDA. This was the ASC Staff’s first audit of the MFDA. The audit was organized and coordinated with the other members of the Canadian Securities Administrators.

Compliance Department

Overall, ASC Staff were satisfied with the operations of the Compliance Department. For the review of mutual fund dealers, the MFDA has developed a very thorough compliance program. Compliance examinations were detailed, well documented and for the most part complete. Compliance officers were well trained and professional. Management reviewed the compliance officer’s work before compliance examination reports were issued to Members.

ASC Staff’s main concern is the timely issuance of examination reports. ASC Staff believe it is taking the MFDA too long to issue compliance reports. Therefore, the Members were unable to start addressing the issues in a timely manner. Long delays may diminish the significance of the findings to the Members and give the Members the impression that the findings are not important to the MFDA.

Membership Application Review Process

Overall, ASC Staff were satisfied with the membership application review process. The membership application review program and the membership form review program were detailed, well-documented and complete. Decisions to grant or deny membership were properly supported by documentation of the work performed.

However, ASC Staff have noted areas which require improvement. Most significantly, ASC Staff are concerned by deficiencies noted during the membership application review process but not addressed by the Member on a timely basis. The MFDA granted membership prior to the resolution of some application deficiencies. The MFDA required the Member to address these deficiencies either through terms and conditions of membership or a “Schedule B”. However, ASC staff noted during review of subsequent

examination files that Members were not resolving all of the deficiencies on a timely basis.

COMPLIANCE DEPARTMENT

1.0 PURPOSE AND SCOPE OF 2004 AUDIT

ASC Staff conducted the 2004 audit to assess the effectiveness of the MFDA Compliance Department by reviewing the adequacy, timeliness and quality of compliance reviews performed by the MFDA Compliance Department from February 6, 2001 to December 31, 2003. ASC Staff also assessed the MFDA Compliance Department's policies and procedures, staff and resources, work and documentation in compliance examination files, follow up procedures, and benchmarks.

ASC Registration Examiners performed the audit, which included:

- Review of the process, policies and procedures of the MFDA's Compliance Department.
- Review of MFDA's Compliance Examination Program.
- Review of Performance Measure Benchmarks.
- Interview with Regional Director.
- Review of a sample of the MFDA's examination files.

2.0 EXAMINATION FINDINGS

2.1 Policies and Procedures Manual

Finding

A review of the MFDA's policies and procedures manual by ASC Staff noted that the MFDA does not have policies and procedures to ensure:

- Reviews of Members occur at a frequency requested by the ASC.
- Cooperation with the ASC in conducting reviews of its Members.

Recommendation

The MFDA should develop policies and procedures which address the above areas and submit a complete policies and procedures manual for ASC Staff review.

2.2 Staffing Compliment

Finding

At the time of ASC's 2004 oversight audit one compliance officer position was vacant and from April 2003 to October 2003, the compliance department employed only one compliance officer. ASC Staff acknowledge that the MFDA has taken steps to rectify the under-staffing of the compliance department; as of

February 2004 there were three compliance officers. However, six months represents a significant period of time during which the compliance department did not have adequate staff to fulfill its responsibilities.

Recommendation

The MFDA must ensure adequate staffing of the compliance department, including filling vacant positions within two months.

2.3 Benchmarks

Finding

The MFDA has established four formal benchmarks with regard to compliance reviews. However, there is no formal tracking of these benchmarks.

One of the MFDA's benchmarks is that if a Member's response to the results of an examination are not acceptable, the lead compliance officer is responsible for following up with a second letter within three weeks of receiving the Member's response. From ASC Staff's review of four examinations which required follow up responses, only one met the benchmark. Two follow up responses were issued 11 and 19 weeks after the MFDA's receipt of the Member's initial response. ASC Staff believe 11 weeks (or longer) to issue a follow up response is unacceptable.

Another MFDA benchmark is that the compliance officers are required to submit their examination file to their supervisor, including complete documentation, within two weeks of completion of the examination. ASC Staff interpret completion of the examination to mean the date field work was completed. ASC Staff's review of four examinations showed that none was submitted within two weeks; the examinations were submitted in 3, 4.5, 7 and 8 weeks. ASC Staff believe 7 weeks (or longer) to submit a file is unacceptable.

Recommendation

The MFDA should monitor whether it is meeting its benchmarks. In cases where benchmarks are not being met, the MFDA should document the reasons for not meeting the benchmark and develop a plan to ensure the benchmarks are met in the future.

2.4 Sample Size Policies, Methodology and Documentation

Finding

The MFDA has not established formal policies for sample selection methodology. From the ASC Staff's review of the Compliance Officer Manual, there was insufficient guidance provided for the methodology of sample selection. MFDA Staff do not document supporting evidence for the selection of sample size or the sample section methodology used in the examination files. In two of the five examination files reviewed, ASC Staff were unable to determine if sample size was representative because there was no documented information on population size. Also in two examination files reviewed, the number of files tested was not documented.

The MFDA's suggested minimum sample size is 10. However, from the review of examination files, ASC Staff noted that this minimum sample size was not always adhered to. In one examination file, MFDA Staff only selected seven new accounts for testing. Given the size of the new account population, ASC Staff do not believe that a sample size of seven is large enough. MFDA Staff did not document an explanation for choosing a sample size smaller than the suggested minimum.

If a dealer is large, the sample size is to be increased, however, the MFDA has no guidelines as to what constitutes a large dealer. There are also no guidelines for situations that warrant an increase or decrease in the sample size. ASC Staff noted in one examination file the compliance officer identified a significant issue during sample testing, however there was no additional testing to determine the extent of the problem.

Recommendation

The MFDA should develop policies with regard to sample selection methodology. Description of population size, determination of sample size and method of sample selection in the MFDA's audit files is necessary to have an adequately documented audit.

2.5 Timely Issuance of Compliance Examination Reports

Finding

ASC Staff assessed the time taken from the date the examination field work was completed to the date the examination report was sent to the Member. This time period includes both the number of weeks to complete the file and the number of

weeks to review the file. From the review of four examinations, ASC Staff noted it took the MFDA 1.75, 3, 5.5 and 6 months to issue the respective examination reports. MFDA compliance officers completed a fifth examination in October 2003. However, as of February 2004, no examination report had been issued. ASC Staff believe an average of over four months to issue a report is excessive.

ASC Staff reviewed a sixth examination where the field work was completed in spring 2003. However, five months later, no examination letter was issued. The reason for the delay in issuance of the report was the extended absence of a compliance officer. ASC Staff believe it not acceptable for an examination report to have been outstanding and not issued for over 5 months after the completion of the field work.

Long delays in the issuance of the compliance reports resulted in an excessive period of time before the Members were able to start addressing the issues identified in the examination. Further, it reduced the effectiveness of the review.

Recommendation

The MFDA should be able to issue an examination report within six weeks of completion of the field work, including the manager review. This would allow for adherence to the current benchmark of compliance officers submitting their examination files within two weeks and provide an additional four weeks for manager review and revisions.

2.6 Completion of Examination Programs

Finding

From the ASC Staff's review of examination files, not all sections of the examination program were completed by the compliance officers. One examination program did not identify key risks and issues in the planning section of the file. Another examination file contained no evidence to indicate the compliance officer had made contact with the relevant securities commissions to review any issues. One planning program specifically stated contact was not made with the securities commission. Two examination files contained no evidence to indicate the compliance officer had reviewed complaints or enforcement issues within the MFDA. The lack of documentation indicates that either the compliance officers did not address these sections of the program, or that the work was done but not documented. It also does not give the manager sufficient information to assess whether the appropriate review procedures were completed.

Recommendation

The MFDA should ensure that documentation of work performed is included in all sections of the examination program. The reasons for not performing a section of the examination program should also be documented.

2.7 Evidence of Resolution

Finding

The ASC audit revealed MFDA compliance officers did not obtain evidence of resolution from a Member with regard to a significant issue identified during the compliance examination. The Member indicated they would resolve an issue by a certain deadline. However, a subsequent examination of the Member by ASC Staff found that the Member had failed to meet the deadline. Since the MFDA compliance officer did not adequately follow up with the Member, the MFDA was unaware the Member had not met the deadline. There is a risk that without proper follow up, Members may fail to adequately and timely address issues raised in the initial examination report. Failure by MFDA Staff to follow up and obtain evidence of resolution of noted deficiencies may diminish the significance of the entire examination process in the eyes of the Members and their staff. ASC Staff believe that given the resources devoted to performing the examination and writing the initial report, the MFDA should continue to follow up all issues until they obtain evidence of resolution from the Member.

Recommendation

ASC Staff believe MFDA Staff should require Member response to document the manner in which an issue will be resolved, the time period for resolution and, if the issue is significant, MFDA Staff should obtain evidence of resolution.

MEMBERSHIP APPLICATION REVIEW PROCESS

3.0 PURPOSE AND SCOPE of 2004 AUDIT

ASC Staff's purpose in conducting the 2004 audit was to assess the fairness, consistency, effectiveness and efficiency of the MFDA membership review process by examining a sample of MFDA membership files. ASC Staff also determined compliance with the applicable provisions of MFDA By-law No. 1.

ASC Registration Examiners performed the audit which included:

- Review of the MFDA's policies, procedures, membership application review program, and membership form review program.
- Review of MFDA new membership files.
- Review of MFDA Member files for reorganizations, resignations, and terminations.

ASC Staff note that the MFDA started accepting membership applications in May 2001 and received over 250 applications, primarily between May 2001 and July 2001. As a result, the MFDA adopted an expedited process for admitting those firms, employing over 55,000 individuals, into membership. ASC Staff acknowledge that, as a result, a number of aspects of the membership application review process changed after the admission of mutual fund dealers that were registered before the recognition of the MFDA as a self-regulatory organization.

4.0 EXAMINATION FINDINGS

4.1 Policies and Procedures on the Membership Application Review Process

Finding

ASC Staff reviewed the MFDA's policies and procedures on the membership application review process in order to understand and assess the adequacy of the policies and procedures. The MFDA did not have adequate policies and procedures on the membership review process in the following areas:

- The MFDA does not have benchmarks and completion timelines for the MFDA membership review process.
- The MFDA does not have written policies and procedures for coordinating with applicable securities commissions on applications for exemptive relief, membership terms and conditions, and new Member applications.

Recommendation

The MFDA should develop policies and procedures to address the above areas.

4.2 Membership Application Review Program

4.2.1 MFDA Recognition Order

The ASC recognized the MFDA as a self-regulatory organization in an order dated April 10, 2001. (“MFDA Recognition Order”). The MFDA Recognition Order imposed certain terms and conditions on the MFDA with respect to the MFDA’s review of applications for membership.

Finding

ASC Staff reviewed the membership application review program to ensure the program covered the areas provided in the terms and conditions of 7(b)(ii) and 7(c) of the MFDA recognition order. Section 7(b) (ii) requires the MFDA to ensure reasonable proficiency requirements (including training, education and experience) with respect to partners, directors, officers, employees and agents of Members. Section 7(c) requires the MFDA to have Members confirm that persons it wishes to sponsor, employ or associate with as Approved Persons comply with applicable securities legislation and are properly registered. ASC Staff found no evidence of review of the proficiency requirements of approved persons. “Approved Person” is defined by MFDA By-Law No. 1 as an individual who is licensed or approved in the appropriate category, where required by applicable securities legislation. Each partner, director, officer, employee and agent of the Member is required to complete a Schedule G acknowledging that they are an approved person and in compliance with MFDA rules. However, Schedule G does not adequately address the risk of an approved person not being registered with the appropriate securities commission and therefore not having the appropriate proficiency requirements. The MFDA should be reviewing the list of approved persons and coordinating with the applicable securities commission to ensure that the approved person is appropriately registered. In addition, ASC Staff believe that it would be prudent to amend Schedule G to include the definition of approved person, thereby having the individual acknowledge that they are registered with the appropriate securities commission.

Recommendation

The MFDA should revise the membership application review program to ensure that all approved persons are and continue to be registered with the appropriate securities commission.

4.2.2 Communication with Securities Commissions

Finding

The membership application review program does not direct MFDA Staff to coordinate with applicable securities commissions on applications for exemptive relief, membership terms and conditions, and new Member applications.

Recommendation

The membership review program should direct MFDA Staff to communicate with applicable securities commissions on membership applications as a formal part of the membership approval process.

4.3 Timely Completion of the Application Form Review Program

Finding

The membership application review does not require documentation of the date started or completed, therefore, ASC Staff were unable to determine if the membership review program was completed on a timely basis.

Recommendation

The application form review program should have an area to document the date the application form review started and the date the application form review was completed.

4.4 Resolution of Terms and Conditions

Finding

ASC Staff found two Members whose membership terms and conditions required the company to establish employment relationships with their approved persons by June 30, 2002. This term and condition had not been addressed by the Members and subsequently removed by MFDA Staff as of February 9, 2004.

Recommendation

The MFDA should ensure that all Members comply with their terms and conditions. MFDA Staff should follow-up with Members to ensure compliance with terms and conditions.