IN THE MATTER OF THE SECURITIES ACT,
R.S.O. 1990, CHAPTER S.5, AS AMENDED

– and –

IN THE MATTER OF
OPEN ACCESS LIMITED

HEADNOTE:

SRO Membership – Application for Exemptive Relief – Mutual Fund Dealers Association – Restructuring of Business – Bifurcation

The applicant brought an application pursuant to s.8 of the Act for a hearing and review of the Director's decision refusing exemptive relief from the requirement to become a member of the MFDA. Applicant is a corporation incorporated under the Ontario *Business Corporations Act*. It is also registered under the Act as an adviser in the categories of investment counsel and portfolio manager (ICPM) and as a dealer in the categories of mutual fund dealer and limited market dealer (conditional). It is currently seeking registration in relevant categories in the provinces of B.C., Alberta, Manitoba, Québec and Nova Scotia. Applicant argued it was not a typical mutual find dealer in that its mutual fund dealer registration is incidental to its core service which is that of group retirement plan administrator. **Held:** The panel declined to grant the exemption requested. The MFDA offers a more rigorous oversight and client protection regime for mutual fund dealers compared to that currently provided under the Act. OAL cannot be distinguished from any of the other investment companies that voluntarily bifurcated their business pursuant to the guidance given by the Commission and who were granted exemptions on a transitional basis only. Roughly 8,000 investors in OAL have requested self-directed accounts that would put them outside the investor protection scheme offered by the MFDA. OAL's June 2003 financial statements concern a "going concern" note from the auditors. The company is in the course of expanding to other jurisdictions across Canada. The long history and policy behind the establishment of the MFDA as the national regulator of the mutual fund industry leads to a conclusion that it is in the public interest that the holders of OAL's self-directed accounts have the benefits flowing from MFDA membership. An exemption granted until March 31, 2004 in order to permit OAL to apply for membership in the appropriate self-regulatory organization as required by the Act.

IN THE MATTER OF THE SECURITIES ACT,
R.S.O. 1990, CHAPTER S.5, AS AMENDED

– and –

IN THE MATTER OF
OPEN ACCESS LIMITED

Hearing:	**November 13 and December 9, 2003.**		
Panel:	**Robert L. Shirriff, Q.C.**	**-**	**Commissioner (Chair of the Panel)**
	Paul K. Bates	**-**	**Commissioner**
	Suresh Thakrar	**-**	**Commissioner**
Counsel:	**Yvonne Chisholm**	**-**	**For the Staff of the Ontario Securities Commission**
	Nigel Campbell **Aleksander Hynna**		**For the Respondents, Open Access Limited**

REASONS

I. The Proceedings

[1]This matter deals with a hearing and review of the Director's decision, pursuant to section 8 of the Ontario *Securities Act* R.S.O., 1990, c. S.5 (the "Act"), dated February 12, 2003 denying Open Access Limited ("OAL") an exemption from the requirement to be a member of the Mutual Funds Dealers Association ("MFDA") which is contained in section 5.1 of the Ontario Securities Commission Rule 31-506 – SRO Membership – Mutual Fund Dealers (the "Rule").

II. Factual Background to the Proceedings

[2]The applicant, OAL, is a corporation incorporated under the Ontario *Business Corporations Act.* It is also registered under the Act as an adviser in the categories of investment counsel and portfolio manager ("ICPM") and as a dealer in the categories of mutual fund dealer and limited market dealer (conditional). It is currently seeking registration in relevant categories in the provinces of British Columbia, Alberta, Manitoba, Québec and Nova Scotia.

[3] On April 27, 2001 OAL sought membership in the MFDA pursuant to its registration as a mutual fund dealer.

[4] On May 31, 2001 the MFDA refused membership to OAL because of the fact that OAL indicated in its application for membership that it offers portfolio management activities with discretionary trading as part of its business model . The MFDA indicated that its sole purpose is to regulate the distribution of mutual funds and a MFDA member may not engage in portfolio management activities with discretionary trading services pursuant to Rule 2.3.4 of the MFDA.

[5] On May 22, 2001 OAL then applied to the Director under section 5.1 of Rule 31-506 for an exemption from the Rule.

[6] On August 30, 2001 OAL's counsel submitted a supplementary application to the Commission for relief from the Rule.

[7] On April 19, 2002 the Commission replied that an exemption could not be granted because of OAL's current business structure. The Commission further indicated that guidance contained within a Commission letter dated December 6, 2000 to The Investment Funds Institute of Canada and the Investment Counsel Association of Canada recommended that a change of the business structure of OAL creating a subsidiary to carry on the mutual fund business and a registration of this entity with the MFDA was the advised solution.

[8] On June 26, 2002, Mr. Warren Laing ("Laing"), Chairman and CEO of OAL, addressed a letter to the Commission in which he explained the business structure of OAL and the reasons why he believed that a restructuring of OAL as suggested by the Commission was not feasible.

[9] Staff of the Commission and staff of OAL then began good faith discussions over a period of some months regarding the terms and conditions that might attach to an exemption, should one be granted. These discussions did not prove fruitful.

[10] On February 12, 2003 the Commission refused OAL exemptive relief from the requirement to become a member of the MFDA. OAL now brings this application pursuant to section 8 of the Act for a hearing and review of the Director's decision.

III. The Issue

[11] Should OAL be granted an exemption from membership in the MFDA, pursuant to section 5.1 of the Rule?

IV. The Position of the Parties

1. OAL's Position:

a) OAL's Business Model

[12] OAL called one witness to the proceeding, Catherine A. Darmody ("Darmody"), Treasurer and Chief Financial Office of OAL. Darmody testified as to the nature of OAL's business structure.

[13] OAL is a group retirement plan administrator. OAL manages group retirement savings plans, deferred profit sharing plans and defined contribution pension plans on behalf of employers. OAL provides an outsource solution to plan sponsors (employers), for their group retirement plans for employees.

[14] OAL's services are marketed almost entirely to corporate pension plan sponsors (corporate employers). OAL does not market its services directly to the public at large and its main competitors are insurance companies.

[15] OAL employs approximately 41 people in carrying out its business as a group retirement plan administrator. These employees include:

a) Laing, who is a registered advisor under OAL's investment counsel and portfolio manager registration. Laing has 39 years of experience in investment advising and portfolio management.

b) customer service representatives, who are responsible for answering plan participants' inquiries regarding their accounts. A customer service representative will sell mutual funds where such a sale is requested by a plan participant (subject to the compliance department's review). As such, the customer service representatives who are involved with assisting plan participants in the purchase of investment products are registered as sales representatives under OAL's mutual fund dealer registration. However, none of the customer service representatives actively solicit trades from plan participants. The customer service representatives do not receive commissions for any trades or sales of mutual funds. They are salaried employees of OAL.

c) business development employees, who actively seek new employers sponsoring employee benefit plans who may be interested in contracting for OAL's services as a group retirement plan administrator. The business development employees do not sell investment products.

d) compliance review department employees, including OAL's compliance officer.

e) various personnel in the processing, finance and other supporting departments.

[16] OAL is registered under the Act as a mutual fund dealer, a limited market dealer, and ICPM.

[17] OAL claims it is not a typical mutual fund dealer under the Act. OAL argues that its mutual fund dealer registration is incidental to OAL's core service which is that of group retirement plan administrator. OAL claims that unlike the typical mutual fund dealer, OAL does not solicit mutual fund sales and does not market mutual funds to members of the public. Instead, it markets it services to the employees almost exclusively within the context of sponsored and managed employee benefit plan portfolios.

[18] OAL has no proprietary investment products and does not manage an OAL sponsored mutual fund or OAL sponsored pooled fund. None of OAL's staff are paid commissions for the sale and purchase of mutual

funds. In short, OAL claims that it bears little or no resemblance to the customary MFDA member.

[19] Once an employer (plan sponsor) has contracted with OAL to act as the group retirement plan administrator, OAL's client implementation team meets with the employees through a group seminar.

[20] The seminars are presented to sponsor's employees (the plan participants) in order to provide information relating to the specifics of the sponsor's chosen retirement plan, and to assist each plan participant in providing OAL with the necessary information.

[21] OAL requests each of the plan participants to fill out an Investor Profile form. The Investor Profile form elicits information relating to the plan participant's investment goals, level of risk tolerance, expected income and investment contribution periods. OAL uses this Investor Profile as a "Know Your Client" form and an enrolment form.

[22] Once each plan participant completes the Investor Profile, OAL's compliance department reviews the Investor Profile in order to ensure that the plan participant's model portfolio account or self-directed account matches the participant's stated goals and risk tolerance.

[23] After accounts are established with OAL, most of the contributions to the plan participants' accounts are deducted through payroll at the plan sponsor level, as well, plan participants may make additional direct voluntary contributions. Plan participants may continue to hold accounts with OAL after leaving their employment with the plan sponsor. These participants may make additional contributions to their accounts, notwithstanding that their accounts are no longer sponsored by their employer.

[24] OAL requires that all plan participants update their Investor Profile on a yearly basis to ensure OAL is providing appropriate investments to each plan participant.

[25] OAL currently has approximately 400 contracts with corporate employers yielding 28,000 clients. It was testified to in the hearing that in August 2001 roughly 72% of these clients had granted discretionary trading authority while 28% of OAL's clients were self-directed.

OAL's model portfolios

[26] OAL has developed nine model investment portfolios (the "model portfolios"). Each of the model portfolios are made up exclusively of brand name mutual funds or index funds. The nine model portfolios occupy successive portions of the investing spectrum from conservative, income-maintenance investing to aggressive growth investing.

[27] Based on the information provided to OAL by the plan participants in their Investor Profile form, one of the model portfolios is targeted as suitable for a plan participant. The suggested model portfolio should reflect the appropriate investment strategy for each plan participant.

[28] OAL selects and monitors the investment products in each model portfolio to reflect the varying levels of risk tolerance and preferred investment strategy of each plan participant.

[29] Laing manages these model portfolios on a discretionary basis and conducts a monthly review of these portfolios. OAL believes that the purpose of this ongoing review process is to ensure that each model portfolio continues to contain investment products appropriate to the needs of the plan participants, and the

investment products are performing acceptably. After his monthly review, Laing adjusts the composition of the model portfolios as necessary. As a result, each managed plan participant's account is adjusted under the discretionary authority to reflect the new composition.

[30] The majority of the total number of plan participants signed up by OAL have subscribed to a model portfolio, and thus have their accounts managed by OAL on a discretionary basis.[1]

[31] OAL argues that its discretionary authority over the majority of enrolled plan participants is central to its operations and business model . Managing the plan participants' accounts on a discretionary basis is a core service that OAL offers to plan sponsors and participants. OAL claims that this core service distinguishes OAL from the "typical" mutual fund dealer. OAL further states that the integration of that service with the element of mutual fund distributions is how OAL is able to provide discretionary portfolio management to plan participants who would rarely qualify for this level of service on their own.

OAL Self-Directed Accounts

[32] In addition to its model portfolios, OAL provides plan participants with the option of opening self-directed accounts. OAL states that this is a necessary component of OAL's services, and the flexibility this allows is an important feature in selling OAL's services to plan sponsors.

[33] The circumstances in which a plan participant may choose to build his or her own portfolio are varied, but include situations such as the following:

a) The plan participant may wish to include GIC's and mutual funds previously purchased prior to enrolment with OAL, in addition to the suggested products in the appropriate model portfolio.

b) The plan participant may wish to follow the appropriate OAL model portfolio with the exception of one or two particular funds.

c) The plan participant may have previously consulted with a financial adviser and may have invested elsewhere. He or she may now wish to ensure that his or her account with OAL complements the pre-existing overall investment strategy.

[34] Two of OAL's employees are registered as mutual fund salespersons. These OAL customer service representatives are available to discuss any changes that a plan participant with a self-directed account may wish to make. They are also available to offer advice on the suitability of a proposed investment. The customer service representatives do not actively solicit or advise trading activity and are not compensated by OAL for any trades performed.

[35] OAL's compliance department reviews any requests by a self-directed plan participant to purchase investment products for suitability, prior to the purchase being made.

[36] OAL requests that plan participants with self-directed accounts submit updated Investor Profile forms on a yearly basis in the same fashion as plan participants with managed accounts. Each year OAL's customer service representatives and the compliance department review all Investor Profile forms to ensure that each plan participant's account, including self-directed plan participants, matches with the plan participant's stated objectives and risk tolerance.

1 Reference paragraph 25.

OAL Fee Structure

[37] As of September 30, 2003, the average plan participant's account was worth approximately $10,755.00

[38] OAL claims it does not charge management fees to the plan participants but does sometimes charge an administrative fee of $84 per client.

[39] As of March 2001 OAL had total assets under administration of $63.1 million (no breakdown was available). In June 2002, OAL had total assets under management amounting to $165.3 million of which 77.6%, $128.3 million, were managed discretionary accounts and 22.4%, roughly $37 million, were self-directed accounts. Also its client base included 146 (employers) corporate plan sponsors, with 18,000 (employees) plan participants. At the date of the hearing, Darmody mentioned OAL had 400 plan sponsors, with 28,000 plan participants; the numbers for assets under management were not available.

[40] Evidence at the hearing indicated that the company derives 20% of its total revenue from administrative fees charged to the employer/plan sponsor and 70% of its total revenue from the trailer fees and deferred sales charges associated with the sale of mutual funds and other investment products in the plan participants' accounts.

[41] OAL's ability to earn direct trailer fees from the sale of mutual funds in both the Model portfolios as well as in the self-directed accounts is the key element in the provision of low-cost, discretionary portfolio management services.

b) Problems with Bifurcation

[42] Darmody testified that OAL's business model depends on its registration as an ICPM. Laing provides investment advice to the plan participants through the selection of suitable investment products in each model portfolio. The provision of discretionary authority allows OAL to ensure that plan participant's accounts remain consistent with individual objectives. This is a significant feature of OAL's business model that provides a competitive edge.

[43] Unlike "typical" mutual fund dealers, who only determine suitability at the time of first sale, OAL monitors the suitability of the mutual fund purchase on an ongoing basis. Even for self-directed accounts, OAL reviews suitability on a yearly basis.

[44] OAL competes with insurance companies for the group retirement plan business. The combination of the provision of investment advice along with limited fees allows for a competitive business model, notwithstanding the smaller asset size of individual plan participant accounts.

[45] Darmody indicated that a forced bifurcation of OAL's business would lead to increased inefficiencies simply for the purpose of ease of regulation or administrative convenience for the regulator.

Increased Costs

[46] Darmody stated that restructuring OAL's business into two separate entities and maintaining duplicate administrations would be costly. Her first estimate of the increased staffing cost was in the neighbourhood of $200,000. Since profit margins were very narrow, these costs would ultimately be passed on to plan sponsors and plan participants. Darmody's evidence indicated that this would result in higher costs to sponsors and

lower net investment returns for plan participants.[2]

[47] Additional costs, other than staffing, of the running of two separate organizations would include the following:

a) increased insurance costs;

b) increased minimum capital requirements;

c) increased administration costs relating to OAL's business especially with regard to OAL's proprietary computer system. The current computer system incorporates pension record keeping, trust accounting and mutual fund dealer functions together. This system enables OAL to deliver its services cost-effectively. Designing new software to accommodate a bifurcated business structure could render OAL's operations less effective, consume time and result in further costs.

d) Increased costs from changes to OAL's current fee structure. OAL derives little or no revenue through its investment adviser activities. After a forced restructuring, OAL may be required to charge adviser services fees in order to cover increased administrative, insurance and capital costs.

Confusion Amongst Plan Participants

[48] Restructuring OAL's business through the creation of two entities would cause confusion among the plan participants and plan sponsors and might cause some participants to leave.

[49] Under restructuring, some plan participants would receive multiple monthly statements of accounts in situations where they have both a managed model portfolio and a self-directed customized portfolio where they now receive only one statement.

[50] The same would be true for plan sponsors who would also receive separate monthly statements from each entity, resulting in potential confusion and difficulty in reconciling the sponsor's retirement plan contributions.

Conflicts Between the Two Business Entities

[51] According to Darmody, the segregation of duties between an investment adviser and mutual fund dealer could create possible conflicts of interest between the two entities in that there could be confusion as to which entity should approach a prospective plan sponsor.

Increased Administrative Complexity

[52] Also according to Darmody, privacy legislation will prevent the disclosure of a plan participant's personal information between the two entities absent the formulation of new and special arrangements to comply.

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2 On December 9, 2003 OAL submitted to this panel evidence regarding anticipatory costs associated with three scenarios of SRO membership. The first was the cost associated with MFDA membership without bifurcation which was estimated would cost the organization $227,102 in year one. The second option was the cost associated with MFDA membership with imposed bifurcation totalling $876,002 in year one. The third scenario involved estimated costs of IDA membership of $617,009 in year one. These costs comprised one-time costs including an increased capital requirement of $200,000 which in the view of the panel is not properly characterized as a cost. We note in paragraph 55 that OAL stated it was prepared to match the MFDA requirements for capital insurance, reporting, etc. if the exemption were granted.

[53] The creation of two separate entities might involve a networking arrangement which could result in the payment of referral fees. This could result in an added level of administrative complexity as OAL expands into other provincial jurisdictions in Canada outside Ontario.

OAL Remains Fully Regulated if Exemption Granted

[54] OAL argues that should an exemption be granted, it would still be sufficiently regulated by the scheme provided under the Act, the Regulations to the Act and the other relevant OSC policies and orders. OAL would still be subject to the reporting and compliance audit requirements of the Act and would still be required to maintain sufficient capital and to hold sufficient insurance pursuant to the scheme as outlined in the Act.

[55] OAL maintains that it is willing to comply with the MFDA's capital, financial reporting and other administrative requirements save for the prohibition against the provision of discretionary trading advice.

2. Staff's Position

[56] Staff's position is that investor protection should be the Commission's primary concern in the exercise of its public interest jurisdiction. Membership in the MFDA offers significant protections for investors which would not be available for the clients of OAL if the company were exempted.

[57] Staff maintains that increased costs were an accepted reality to Rule 31-506 and the recognition of the MFDA. The Commission must be taken to have concluded that the benefits of MFDA regulation, investor protection above all, warranted the increased costs and administrative inconvenience for mutual fund dealers. Staff submits that investor protection clearly eclipses any financial burden or logistical inconvenience that OAL may experience in joining the MFDA.

[58] Staff argues that to permit OAL to be exempted from membership in the MFDA would leave its existing and prospective mutual fund clients without the significant safeguards and protections that flow from MFDA oversight.

[59] Staff notes that OAL describes the mutual fund aspect of their business as "incidental" to its main business yet it indicates that it earns substantially all of its revenue through mutual fund dealership activities.

[60] Staff points out that the existence of Rule 31-506 and the creation of the MFDA have required a number of other companies to bifurcate their discretionary trading services from their mutual fund dealership activities.

[61] Staff notes that the issue of bifurcation was suggested three years ago in a December 6, 2000 letter published by the Commission and directed to those companies where the two types of businesses (discretionary and self-directed) were merged. At that time the Commission indicated that the key public interest goal of investor protection mandated a bifurcation of the two businesses.

[62] Staff remarks that 8,000 investors would be outside the benefits provided by the MFDA scheme and that the MFDA is a national regulator. This is pertinent since OAL is currently planning to expand into five other provinces.

V. Analysis and The Law

1. The History and Purpose of Membership in the MFDA

[63] We acknowledge that the Rule came into force after a very lengthy process which began with the release of Commissioner Stromberg's report entitled: "Regulatory Strategies for the Mid-90's – Recommendations for Regulating Investment Funds in Canada" (the "Stromberg Report"). This Report recommended the creation of a national self-regulatory body for all mutual fund dealers.

[64] The Stromberg Report recommended that there be a national self-regulatory body for all mutual fund dealers and that the regulatory structure for investment funds be simplified by combining provincial resources into a single centralized regulatory body.

[65] The purpose of the Rule was to give effect to the principle in paragraph 4 of section 2.1 of the Act that the Commission should, subject to an appropriate system of supervision, use the enforcement capability and regulatory expertise of recognized self-regulatory organizations.

[66] The Rule was first proposed and published for comment in 1997. As early as June 2000, mutual fund dealers were specifically advised to "begin to plan for the transition under this proposed Rule immediately."[3]

[67] In October 2000 the Commission again announced that it had approved the Rule and instructed mutual fund dealers to begin planning "for the effective date and the requirements of the Rule immediately." [4]

[68] In February 2001 the Commission reminded the industry that "mutual fund dealers should begin to plan for the effective date and the deadlines provided for in the Rule immediately."[5]

[69] In the course of the evolution of the Rule and the formation of the MFDA, more than 430 comment letters were received, considered and addressed. In an October 2000 Notice, the Commission highlighted a comment received from a member of the public to the effect that membership in the MFDA should not be mandatory for firms registered as advisers in the ICPM category and also as mutual fund dealers:

> Substance of Comment: Membership in the MFDA is inappropriate for companies registered as advisers in the category of investment counsel/portfolio manager (ICPMs) and who are also registered as mutual fund dealers. Certain of these registrants also sell units of mutual funds that are managed by them and sold to clients who have signed discretionary management agreements with them. ICPMs acting in this manner should be required to be registered as mutual fund dealers and therefore would be expected to be members of the MFDA. However, where an ICPM manages assets on a discretionary basis and in the course of such management, also distributes units of its managed private pooled funds, an exemption from membership in the MFDA is appropriate. It was suggested that membership in the MFDA should be required to the extent that the ICPMs in question offer mutual funds on a non-discretionary basis (in respect of the non-discretionary portion of their business).[6]

[70] The Commission noted in this same Notice that it had not yet amended the proposed Rule to differentiate amongst the various companies registered as mutual fund dealers. It further indicated

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3 **Notice of Proposed Changes to Proposed Rule 31-506 – SRO Membership – Mutual Fund Dealers**, June 16, 2000, (2000)23 OSCB(Supp.)163.
4 **OSC Rule 31-506 – SRO Membership – Mutual Fund Dealers**, October 13, 2000, (2000) 23 OSCB 7013.
5 **Notice of Rule – OSC Rule 31-506 – SRO Membership – Mutual Fund Dealers** February 16, 2001, (2001) 24 OSCB (Supp.) 1.
6 **Supra Footnote 4** at p. 7015**.**

that in the case of registered mutual fund dealers, who carry on the principal business of acting as sponsor and manager of mutual funds and who do not wish to become members of the MFDA, they should change their business structures and surrender their registration as mutual fund dealers

[71] Guidance to this public comment was finally given in the form of a response letter written by Rebecca Cowdery, Commission Staff[7], on December 06, 2000 (the "December Letter"). This letter was addressed to the Investment Funds Institute of Canada and the Investment Counsel Association of Canada.

[72] The December Letter indicated that in cases where a portfolio manager sells mutual funds pursuant to a prospectus directly to the public, it is appropriate for that registrant to be registered as a mutual fund dealer and to be subject to the Rule. The issue of exemption was considered and it was further indicated that an exemption would not be feasible where it would leave the MFDA regulating only a portion of assets administered by a member. Portfolio managers who were selling mutual funds were advised to consider altering their business structure to conform to the Rule:

> With respect to exemptions from certain MFDA rules, MFDA staff have noted the difficulties inherent in attempting to regulate only a portion of the assets administered by a member and therefore exemptions from the relevant MFDA rules may not be feasible. As a result, registrants concerned about the impact of MFDA rules upon their business may wish to consider the advice of the Ontario Securities Commission noted in the Notice of Rule 31-506 SRO Membership – Mutual Fund Dealers at (2000) 23 OSCB 7015 – namely, changing their business structure by creating a subsidiary to carry on their mutual fund distribution business, surrender their existing registration as mutual fund dealers and register the subsidiary instead. The subsidiary would then be required to be a member of the MFDA and subject to all of its rules.[8]

[73] On February 6, 2001, the MFDA was recognized by the Commission as a self-regulatory organization pursuant to section 2.1 of the Act and the Rule came into force on April 23, 2001.

[74] The goal of the MFDA is to regulate the "operations and standards of practice and business conduct of its members and their representatives with a view to promoting the protection of investors and the public interest."[9]

[75] The primary objectives of the MFDA are:

- to encourage through self-regulation a high standard of conduct among members with regard to mutual fund distribution in Canada;

- to adopt, and enforce compliance with, such practices and requirements as may be necessary and desirable to maintain such standard in the interests of members, their clients and the public;

- to regulate members of the MFDA and persons who are or were shareholders, partners, directors, officers or employees of such members;

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7 The letter authored by Ms. Cowdery represents a reply on behalf of Commission Staff from the following provinces: British Columbia, Alberta, Saskatchewan, Manitoba and Ontario. (2000) 23 OSCB 8467-8469.
8 **Ibid** at page 8468.
9 **Description of the Structure and Self-Regulating Activities of the MFDA**, June 9, 2000,(2000) 23 OSCB (Supp.) 183 at p. 188.

- to establish requirements for membership in the MFDA and the approval of individuals in respect of such members, and to monitor and enforce the same;

- to investigate, mediate and arbitrate grievances pertaining to the public, members and approved persons;

- to establish and maintain a compensation or protection fund for clients of members; and

- to facilitate members conferring amongst themselves on matters of common concern, including consultation and co-operation with governments, regulators etc.[10]

[76] The MFDA offers a more rigorous oversight and client protection regime for mutual fund dealers compared to that currently provided under the Act.

[77] The MFDA Rules set out qualifications for mutual fund salespersons, branch managers, trading partners, directors, officers and compliance officers. They also prescribe standards of business conduct, involving the handling of business accounts and minimum standards of supervision specifically designed for the mutual fund industry in Canada. The MFDA policies outline the training and supervision of new registrants.[11]

[78] The MFDA Rules prescribe that members must file annual audited financial statements as well as an annual audited financial questionnaire and reports ("FQRs") and quarterly unaudited FQRs (until March 2004). After March 2004, members will have to report on a monthly basis. Under the Act, mutual fund dealers are required only to submit annual audited financial statements.[12]

[79] The MFDA also provides for an early warning system which allows the MFDA the opportunity of imposing stringent requirements on those dealers whose recent financial results indicate that they are, or may soon be in, financial difficulty. Early warning tests form part of the basis of the FQR reporting system. There is no such provision in the Act for mutual fund dealers.[13]

[80] The MFDA has a capital requirement of $200,000 as opposed to a capital requirement of $25,000 under the Act.[14]

[81] The MFDA requires members to maintain minimum insurance coverage of $500,000 for Level 4 Dealers such as OAL as opposed to an insurance coverage of $200,000 under the Act.[15]

[82] MFDA members must observe a mandatory client complaint process which requires each member to establish procedures to deal with client complaints that involve acknowledgment of the complaint to the client, and a conveying of the results of all investigations in writing to the client with the maintenance of records for seven years after the date of the complaint.[16]

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10 **Ibid** at page 189.
11 Mutual Fund Dealers Association of Canada Rules as of February 23, 2001. Rules 1 and 2. Also MFDA Policy No. 1 as of February 23, 2001.
12 **Ibid** Rule 3.5.1
13 **Ibid** Rule 3.4 in its entirety.
14 A capital requirement requires members to keep allowable working capital on hand where "working capital" is defined as "the excess of current assets over current liabilities". See Sections 107(1) and (6) and 96 of Regulation 1015 of the Act and Rule 3.1.1. of the MFDA Rules.
15 **MFDA Rule 4.4.1** and Section 108(4), Regulation 1015 of the Act.
16 **MFDA Policy No. 3** – Handling Client Complaints

[83] Whenever a client of a member of the MFDA complains of theft, misappropriation, or forgery, it is mandatory that the complaint be conveyed to the MFDA for investigation and enforcement proceedings, if warranted, as set out in Policy No. 3.

[84] Each MFDA member is required to participate in an ombudservice ("OBSI") which is independent of the MFDA, the government and the financial services industry. The OBSI investigates complaints after the client has exhausted the firm's internal complaint process. The OBSI provides an independent and impartial investigation and offers a forum for the resolution of complaints. It can also make a non-binding recommendation for compensation of up to $350,000. This service is free of charge to clients of the MFDA and confidential. [17]

[85] The MFDA is currently seeking public comment on a proposed investor protection plan ("IPC") that would protect clients of members of the MFDA. The primary purpose of the IPC would be to provide protection to eligible clients of MFDA members in the case of insolvency of the member up to a maximum claim per client of $100,000. The Act provides for the Ontario Contingency Trust Fund which allows individual claims to a maximum of $5,000.[18]

[86] The MFDA does not regulate portfolio management activities and a member of the MFDA may not engage in portfolio management because the MFDA Rules specifically prohibit discretionary trading. The Rules prohibit a member or approved person from accepting or acting upon a general power of attorney or similar authorization from a client. Rule 2.3.4 provides:

> **No Discretionary Trading.** A limited trading authorization shall not in any way confer general discretionary trading authority upon a Member, an Approved Person or any person acting on behalf of the Member.[19]

[87] Section 5.1 of the Rule permits the Director to grant an exemption to the Rule, in whole or in part, and subject to such conditions or restrictions as may be imposed in the exemption.

[88] Exemptions are commonly granted by the Commission where the applicant is registered, or has applied to be registered, as a mutual fund dealer and where the mutual fund trading activities represent a part of the principal business of the applicant and where the applicant is in the transition phase of transferring its mutual fund activities to a subsidiary or to a third party who will become a registered member of the MFDA. See:

- **Re Lincluden Mutual Fund Dealer Inc.** (2002), 25 OSCB 8238
- **Re Integra Capital Corporation** (2002), 25 OSCB 5038
- **McGee Capital Management Limited** (2002), 25 OSCB 5033
- **Re All-Canadian Management Inc.** (2002), 25 OSCB 5030
- **Re TD Asset Management Inc.** (2002), 25 OSCB 3676

17 **Member Regulation Notice** – Client Complaint Information, MR-0020, October 21, 2003.
18 **Notice and Request for Comment – Application for Approval of MFDA Investor Protection Corporation** (2002), 25 OSCB 8095 and see Section 110 of Regulation 1015 to the Act.
19 **Supra Footnote 11.**

- **Re Howson Tattersall Investment Counsel Ltd.** (2001), 25 OSCB 656
- **YMG Capital Management Inc.** (2001), 24 OSCB 4707
- **Re Pursuit Financial Management Corp.** (2001), 24 OSCB 3605
- **Re Hirsch Asset Management Corp.** (2001), 24 OSCB 3606

2. The Nature of OAL's Business

[89] OAL's submission in favour of the exemption was based on the contention that its business is unique from most mutual fund dealerships.

[90] OAL argued that it does not market mutual funds to the public at large, their clientele being corporate employers. However we note that the business with corporate employers does in fact yield OAL members of the public as plan participants. The evidence at the hearing indicated that 28% of the 28,000 investors in OAL have requested self-directed accounts that would put them outside the rigorous investor protection scheme offered by the MFDA should this exemption be granted.

[91] OAL also argued that the mutual fund dealership aspect of their business is incidental to its core service which is to function as a "retirement plan administrator" with mutual fund services incidental to their core business. We do not see how this distinguishes OAL from any of the other investment companies that voluntarily bifurcated their businesses pursuant to the guidance given by the Commission and who were granted exemptions on a transitional basis only.[20]

[92] OAL insisted in its submissions that it could not see the public interest in forced bifurcation. To OAL, forced bifurcation of its business was seen to be a matter of "administrative convenience" to the regulator. We are concerned that OAL has not discerned, or chosen to ignore, the objectives inherent in the creation of the MFDA.

[93] OAL derives most of its revenue from trailer fees arising from the sale of mutual funds. Of the net assets under management, as of June 2002[21], roughly $37 million derive from self-directed accounts. This is not an inconsiderable amount.

[94] OAL argued that there were many aspects of MFDA regulation by which it was prepared to abide voluntarily should it be granted an exemption, such as: capital requirements, monthly filings of financial statements, early warning system (if imposed), and insurance requirements.

[95] On the evidence, it appears that the most prohibitive aspect of the bifurcation of OAL's operations to permit it to obtain MFDA membership with respect to the self-directed portion of the business, is the potential confusion to and loss of clients and cost. We note however, that in cross-examination Darmody did not reject the suggestion that potential confusion to clients could be addressed through proper communication and explanation although she was concerned that some clients might leave. We also note that although Darmody expressed the view that the cost of bifurcation might require OAL to charge additional fees and thus pose a "risk" to the business, on balance we do not consider that this should constitute grounds for the exemption it

20 Reference paragraph 88.
21 The most recent figure available on the day of the hearing.

seeks.

[96] We also note that at the hearing it appeared that although OAL has been in business since 1996, its June 30, 2003 audited financial statements contain a "going concern" note from the auditors. Darmody indicated this note was inserted because OAL was "... not yet earning a regular monthly profit." It was still in start-up mode. Also the company is in the course of expanding to other jurisdictions across Canada and according to financial information submitted to the panel, the company might not be profitable for several years.

[97] The long history and policy behind the establishment of the MFDA for investor protection reasons lead us to the conclusion that it is in the public interest that the holders of OAL's self-directed accounts have the benefits flowing from MFDA membership.

VI. The Decision

[98] For the reasons noted above, we decline to grant the exemption requested and instead grant an exemption from membership in the MFDA until March 31st of 2004 in order to permit OAL to apply for membership in the appropriate self-regulatory organization as required by the Act.

DATED at Toronto this 4th day of March, 2004.

"Robert L. Shirriff" "Paul K. Bates"

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Robert L. Shirriff, Q.C. Paul K. Bates

"Suresh Thakrar"

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Suresh Thakrar