Draft: January 4, 2005

Summary of Public Comments
Respecting
Application for Approval of
MFDA Investor Protection Corporation
And
Response of the MFDA and MFDA IPC

On November 29, 2002, the Ontario Securities Commission (the "OSC") published for comment the Application (the "Initial Application") of the Mutual Fund Dealers Association of Canada (the "MFDA") and the MFDA Investor Protection Corporation (the "IPC") for the approval by the OSC of the IPC as a compensation fund, pursuant to subsection 110(1) of R.R.O. 1990, Regulation 1015, as amended, made under the Securities Act R.S.O 1990, c.S.5, as amended. The Initial Application was published in Volume 25, Issue 48 of the Ontario Securities Commission Bulletin, dated November 29, 2002. The Application was simultaneously filed with the Executive Director of the British Columbia Securities Commission, the Alberta Securities Commission, the Saskatchewan Securities Commission, the Manitoba Securities Commission and the Nova Scotia Securities Commission (together with the OSC, the "CSA Members") for approval, designation or consideration, as the case may be, of IPC by those CSA Members. The OSC has acted as the principal or lead CSA Member for the purposes of the Application and co-ordinating comments.

The Initial Application included a draft application for letters patent for IPC (the "Letters Patent"), draft by-law No. 1 of IPC (the "By-laws"), draft MFDA policy relating to IPC coverage (the "Coverage Policy"), proposed MFDA rule relating to IPC advertising (the "Advertising Rule") and proposed MFDA policy relating to IPC advertising (the "Advertising Policy"). The contents of the Initial Application addressed the subject of the seven criteria identified by the Commissions and reproduced as the CSA Criteria in the Initial Application.

The public comment period in respect of the Initial Application expired on January 24, 2003. A number of comments were received (which are reviewed and responded to below) concerning primarily whether an investor protection fund for MFDA Members were necessary at all or, if it were, whether the protection should be similar to that of the Canadian Investor Protection Fund ("CIPF") or part of CIPF. The Board of MFDA considered these comments and concluded, subject to certain conditions, that the prospect of MFDA participating in CIPF should be pursued. Accordingly, during the spring and summer of 2004 discussions were commenced with the board and management of CIPF. The nature and conclusions of such discussions are described in the revised Application referred to below, but it was determined that the Initial Application of MFDA IPC and MFDA would be amended and resubmitted.

On November 15, 2004, MFDA IPC and MFDA submitted a revised Application (the "Revised Application") to replace the Initial Application with the expectation that the

relevant CSA Members would publish the Revised Application for comment. The Initial Application as amended by the Revised Application is referred to as the "Application". At the same time it was considered useful that a Summary of Public Comments and the Response of MFDA IPC and MFDA respecting the Initial Application should be published. However, in order to ensure that the responses of MFDA IPC and MFDA are current, the responses with respect to the Initial Application have been updated to reflect where appropriate amendments were made in the Revised Application. Accordingly, the responses set out below should be read together with the Initial Application as revised and replaced by the Application of November 15, 2004.

Seven comment letters were received during the public comment period:

1. CIBC Securities Inc., Royal Mutual Funds Inc., BMO Investments Inc., National Bank Securities Inc., Scotia Securities Inc., TD Investment Services Inc., HSBC Investment Funds (Canada) Inc. and LBC Financial Services Inc. by their counsel, Stikeman Elliott, (January 23, 2003) *(The commentators represented in this letter are collectively referred to in the summary of comments below as the "Bank-owned Dealers")*

2. The Investment Funds Institute of Canada ("IFIC") (January 24, 2003).

3. BMO Mutual Funds (January 24, 2003).

4. Scotia Securities Inc. (January 24, 2003).

5. PFSL Investments Canada Ltd. (January 22, 2003).

6. Rice Capital Management Plus Inc. (December 10, 2002).

7. Royal Mutual Funds Inc. (January 24, 2003).

8. Federation of Independent Mutual Fund Dealers (the "Federation") (January 24, 2002).

Copies of comment submissions may be viewed at the office of the MFDA, 121 King Street West, Suite 1600, Toronto, Ontario by contacting Greg Ljubic, Corporate Secretary, (416) 943-5836.

The following is a summary of the comments received, together with the MFDA's responses to the Initial Application and updated to reflect the Application of November 15, 2004.

The Board of Directors of the IPC, the Board of Directors of the MFDA, MFDA staff and counsel have considered carefully all of the comment letters and observations made with respect to the Application. In addition, the IPC Chair and MFDA staff have had the opportunity to meet personally with many of the persons submitting comment letters.

The responses set out below with respect to the various issues identified benefit from discussions with the persons making the comments. In addition, the IPC Chair and MFDA staff have been able to meet with representatives of Canadian Investor Protection Fund and also to discuss the relevant issues with representatives of the CSA Members including the OSC as the lead CSA Member for purposes of the application and co-ordinating comments as indicated above.

1. General Comments

1.1 Need for MFDA IPC

All the commentators expressed support for the general goal of consumer protection, but they also expressed concern with the need for the IPC, or various aspects of the IPC, as proposed.

The Bank owned Dealers and Rice Capital questioned whether a compensation fund for clients of mutual fund dealers was necessary. These commentators noted the relatively low risk business operations and activities of mutual fund dealers, in particular the fact that the majority of mutual fund assets are held in client name, and the historically low level of mutual fund dealer insolvencies and client losses. One commentator believed that further analysis of the mutual fund industry is necessary before establishing a compensation fund.

The Federation and PFSL supported MFDA IPC as an initiative but wished to have certain matters clarified and expressed concerns with aspects of the plan.

A general concern was expressed that the additional costs, duplication and inefficiencies related to MFDA IPC do not justify its creation. The extra costs are borne by the investing public and the protection provided is limited.

The Bank-owned Dealers pointed out that if it was determined that a compensation fund for mutual fund dealer customers were considered to be necessary, a number of alternatives to MFDA IPC were more appropriate (see Alternatives to MFDA IPC below.)

The Bank owned Dealers also observed that dealers in the United States who restrict their business to the distribution of mutual funds are not required to participate in a contingency fund, and consistency between Canadian and U.S. securities laws is important.

The view was also expressed that the establishment of MFDA IPC was not required to satisfy the terms and conditions of MFDA's recognition orders by the relevant CSA Members.

Rice Capital commented that a bigger concern than MFDA Member insolvency is the stability and financial worth of the mutual fund issuers and their management

companies. In addition, the creation of MFDA itself and other risk-reducing developments including fiduciary bonds to cover fraud and misrepresentation may make IPC unnecessary. On this basis, Rice Capital considered that the only reason for IPC would be to enable the quick settlement of a customer's account in the event of problems However, it would be better if a CompCorp model were followed under which all industry participants such as fund companies, dealers, managers and other sales agents agreed to pool together quickly to settle claims and thereby put mutual responsibility on all participants. Rice Capital was also concerned that client restitution by IPC may make criminal charges against deceitful salespersons less likely.

MFDA Response

Initial Application

To the extent that commentators have suggested that it is not necessary that a compensation fund for clients of mutual fund dealers be established, IPC has confirmed with CSA Members its understanding that such a fund or similar protection plan is necessary. IPC and MFDA understand that many of the commentators including the Bank-owned Dealers understand and accept (although reluctantly) this premise.

Notwithstanding the foregoing assumption that a protection plan is required, commentators suggested that alternatives to the IPC ought to be considered. IPC agrees with this comment and alternatives to an MFDA IPC are discussed in the following section. IPC also accepts the observation that a number of the detailed aspects of the protection plan to be offered by IPC remain to be determined and that such details will be important for assessing the viability and efficiency of the Plan.

The MFDA and IPC acknowledge the proposition that customer protection in the event of an MFDA Member insolvency ought to be made available on the most efficient and cost-effective basis possible, subject to maintaining appropriate levels of public protection. Although customer protection can only be provided with some additional cost, MFDA and IPC believe the structure of IPC minimizes any duplication or inefficiencies in cost.

The fact that mutual fund dealers in the United States are not required to participate in a contingency fund may have some relevance to whether IPC is necessary but, as indicated above, IPC has made its application on the basis of its understanding that the CSA requires a protection fund. Similarly, the fact that the specific terms and conditions of MFDA's recognition orders do not mandate IPC is irrelevant for the same reason, although it may be observed that the recognition orders clearly contemplate that a protection fund will exist.

The comment directed to the need for ensuring the financial stability of mutual fund issuers and management companies has been raised in the past. IPC and MFDA would agree that any measures to reduce risk to consumers in the mutual fund industry that are available at reasonable cost are worthwhile to consider. However, the MFDA

and IPC are only able to consider the role of mutual fund dealers, and mutual fund issuers and management companies are not members of MFDA. In addition, the model of CompCorp in the insurance industry as establishing a pool of product issuers, managers and distributors (dealers) was suggested as an objective. However, we do not believe that CompCorp pools the resources of any insurance industry participants other than life insurance companies and IPC is not aware of any other industries in which fully integrated protection is available.

Lastly, the comment on the effect of customer compensation in the criminal process is not, in the view of MFDA and IPC, supported by the experience in Canada or the United States. In the recent major insolvencies handled by CIPF (Osler, McConnell and Company, Essex Capital Management) successful criminal prosecutions have followed. (The cases of Rampart Securities and Thomson Kernaghan have not been completed.) There is generally the same experience in the United States where the principals of firms liquidated by SIPC are often prosecuted. Apart from the motives of customers, the compensation funds and the security industry itself have a great interest in encouraging prosecutions for deterence and other reasons.

Revised Application

No change.

1.2 Alternatives to MFDA IPC

The Bank-owned Dealers commented that better alternatives to the IPC need to be considered. In particular, the Bank-owned Dealers strongly supported the alternative of requiring the MFDA to join CIPF as a participating institution. The Bank-owned Dealers were of the view that the assessments would be substantially lower, the monetary and coverage protection to clients would be dramatically superior and there would be no new bureaucracy or cost structure created. It was also noted that in the event of a serious insolvency in the securities industry, there would be a greater number of participants to draw on, thus benefiting all participants.

The following alternatives were also suggested by the Bank-owned Dealers:

- Require those mutual fund dealers that hold assets in nominee name to obtain third party insolvency insurance, guarantees or other financial assurance from a credit worthy financial institution.

- Require mutual fund dealers to make insolvency protection available to clients upon request, at the electing client's cost.

- Do not provide insolvency protection at all and require clear notice to clients of the absence of contingency fund protection.

- Continue the Ontario contingency trust fund and equivalent schemes for mutual fund dealers in other provinces, with continued modest assessments for mutual fund dealers holding assets in client name based on their much lower risk profile.

MFDA Response

Initial Application

A number of alternatives to a separate MFDA IPC plan were proposed. The strongly supported alternative of requiring MFDA to join Canadian Investor Protection Fund ("CIPF") is under review by MFDA and IPC and has been discussed directly with representatives of CIPF as well as the CSA Members. It should be noted this proposal was one of the original options identified by MFDA, CIPF and the industry committees formed to assist in the development of MFDA and it has had, accordingly, consideration before IPC's application. Although a combined plan was initially rejected for a variety of reasons, it was considered again in more detail immediately after the current IPC application was made in November 2002. There are a number of aspects to the MFDA joining CIPF and having, in effect, a single fund for the securities industry. It is often noted that the respective businesses of mutual fund dealers and investment dealers are quite different and, accordingly, the risks and costs of providing insolvency protection differ. The MFDA and IPC expect to pursue this alternative in the next few months but have already identified a number of significant considerations for MFDA Members and the public. In view of the universal observation that costs in the Canadian securities industry must be controlled, MFDA and IPC are attempting to assess the costs and benefits of the proposal to join CIPF. A paper dealing with this subject is in the process of being prepared at the request of a subcommittee of the MFDA Board which is reviewing the matter.

It was suggested that mutual fund dealers who hold assets in nominee name may be able to obtain insolvency insurance, guarantees or other financial assurances in the commercial markets in lieu of establishing a protection plan. The experience of representatives of IPC and others is that such insolvency protection is not readily available, if at all, in insurance markets and the proposal is not viable.

The suggestion that insolvency protection be available at the option and cost of clients of Members raises a number of regulatory implications. The ability of a client to assess whether insolvency protection is desirable or necessary is uncertain, but the drastic consequences if such protection is not available and client assets are lost would indicate that strong assurances that clients are able to assess such risks are important. MFDA and IPC are of the view that such assessment would be difficult for many clients. Coverage provided on an optional, on request basis, is likely to be expensive because the economies of establishing a larger fund will not be gained. In addition to the foregoing, the complications arising from the administration of such an arrangement, public disclosure and the administration of insolvency suggests that the proposal is not practical. In addition, the MFDA and IPC view the alternative of simply providing clear

notice to clients of the absence of contingency fund protection as not addressing the public interest concern.

A further suggestion was made that the existing provincial contingency funds such as those that exist in British Columbia, Ontario and Nova Scotia be continued with possible adjustments in coverage, assessment and administration to better reflect the business of mutual fund dealers. MFDA and IPC are of the view that national protection is important and, as indicated, not all provinces have such protection plans. In addition, the existing plans are not uniform in application and are, by general recognition, somewhat archaic in their coverage limits and ability to participate in dealer insolvencies

Revised Application

The Revised Application describes the extensive discussions and review with CIPF and the fact that those discussions are expected to continue following the establishment of IPC.

2. IPC Application and Approval Process

2.1 Lack of MFDA Member Input in Development of MFDA IPC

The Bank-owned Dealers felt that MFDA Members have not had the opportunity to provide input into the Application or the structuring of the IPC. These commentators were of the view that the details of any proposed contingency fund that is mandated by the MFDA, as well as the proposed assessment methodology and any future changes thereto, must be approved in advance by MFDA Members on the basis that MFDA is to represent Members.

MFDA Response

Initial Application

The whole development of MFDA including the proposed IPC has been premised on strong mutual fund dealer participation. The initial rules adopted for MFDA as part of its recognition in February 2001 were based on the input of industry committees including a committee that focused on capital and contingency fund requirements. In addition, the MFDA Board, which has directed the development of IPC over the past couple of years has strong representation from all MFDA Member businesses including, in particular, the Bank-owned Dealers and other independent dealers. Lastly, the purpose of publishing for comment the proposed model for MFDA IPC was to elicit comments from not only industry participants but regulators and the public. No significant aspect of IPC will be adopted without the approval of the MFDA and, in that regard, MFDA Members are well represented on the MFDA Board and in other capacities. This latter comment is particularly true in view of the proposed adoption of the recommendations of the MFDA Corporate Governance Committee whose February 2003 Report is available to the industry and the public.

Revised Application

MFDA has been particularly conscious of the need to assess the effect of MFDA IPC on its various Members as well as the mutual fund distribution industry as a whole. As examples, in the review of joining CIPF, detailed and comprehensive questionnaires were sent to all Members (more than once to those who did not respond). In addition, the Bank-owned Dealers have continued to make representations to both the MFDA and CSA, and MFDA has participated in such discussions and will continue to do so.

2.2 Lack of Essential Information Needed to Properly Analyze the Application

The Bank-owned Dealers stated that it is impossible to undertake a meaningful analysis of the MFDA IPC in the absence of any information regarding such matters as predicted risk of losses and the extent of historical losses. These commentators also expressed concern that this information was not made available to members of the MFDA Board in considering the IPC Application.

MFDA Response

Initial Application

The observation by certain commentators including the Bank-owned Dealers on the lack of meaningful history and analysis with respect to risk and losses is acknowledged both by MFDA and IPC. However, the fact is that very little information of that kind is available. On the other hand, the persons involved in the development of IPC including its Chair (Don Leslie, former President of CIPF), industry members, MFDA staff and counsel have considerable experience in dealer insolvencies and are able to provide the best available assessment of risks, projected losses, etc. It is expected that as experience and knowledge is gained while IPC operates, its structure and operations could be modified.

Revised Application

No change. However, MFDA supports any efforts or information that would assist in more accurately identifying levels of risks and projected losses.

2.3 Lack of Analysis of Alternatives and their Costs and Benefits

The Bank-owned Dealers expressed concern that the IPC Application did not contain a meaningful discussion and analysis of alternative methods of providing protection to clients of mutual fund dealers and accompanying cost-benefit analyses, particularly as they relate to the funding of MFDA IPC. It was noted that the adoption of rules by CSA Members such as the OSC requires consideration of such matters.

IFIC stated that its members have expressed concern due to the lack of a funding formula in the Application and noted that it is impossible to complete a cost benefit analysis of the IPC without a clear formula.

MFDA Response

Initial Application

As indicated in the response to the foregoing section, it is acknowledged that limited data and objective cost / benefit analysis is available. In this regard, it may be noted that some sophisticated studies and risk / actuarial reviews have been conducted in the United States with respect to securities dealers but not mutual fund dealers. On the other hand, as indicated above, MFDA and IPC are currently preparing the best cost benefit analysis that can be considered which, although it will not be perfect, will be helpful and generally accurate. A number of discussions have been held with CIPF in this regard as well. This comment extends to the express desire for a clear funding formula. As described in the Application, the MFDA and IPC believe that funding on the basis of assets under administration is appropriate at this stage in the development of IPC and that the projections for the target size of the IPC fund are reasonable in the circumstances. As explained in section 5 of these Responses, the intention is to begin with a relatively small size fund and consider on an annual basis whether and how the fund should be increased as experience is gained.

Revised Application

No change. Reference is made to the discussions with CIPF and the intention of MFDA and MFDA IPC to review on a periodic basis all aspects of IPC including fund size, assessment made and coverage.

2.4 Concerns Regarding the Legal Basis under which the IPC proposes to be Approved and Operate

The Bank-owned Dealers indicated that there are concerns as to the legal basis under which the IPC proposes to be approved and operate. They identified these concerns as arising from three separate factors that can be summarized as follows:

2.4.1 Securities

The OSC is proposing to approve the IPC as a contingency fund under section 110(1) of the Regulations. However, section 110(1) of the Regulations relates to the approval of a fund, not a person. The fund is not intended to be a legal entity itself, but to be established by legal entity. Therefore the IPC, as a person would not appear to qualify. In addition, securities legislation in Ontario, British Columbia and Nova Scotia appears to explicitly limit approval to a fund established by the IDA or a recognized stock exchange. If a contingency fund is to be mandated under these provisions, the

jurisdiction seems at best to be limited to requiring Members to participate in the existing CIPF.

MFDA Response

Initial Application

The MFDA and IPC have discussed with the relevant CSA Members the legal basis on which IPC could be recognized or approved as a fund for the purposes of applicable securities legislation. The MFDA, IPC and members of the CSA are satisfied that the relevant statutory provisions refer to a fund of the kind proposed in the Application.

Revised Application

No Change.

2.4.2 Insurance

It appears that the IPC will be engaged in the business of insurance without complying with applicable insurance laws. The IPC appears to rely on the principle that insurance laws are not implicated if payments to clients are "discretionary". However, the language of the Application materials, in particular references to "claims", "coverage" and "protection" and references to facilitating clients' ability to sue the Corporation and the terms and conditions of the proposed approval order (e.g. section 4) suggest that this in fact not the case. Participation by MFDA Members in the IPC could expose them to potential liability under insurance laws.

MFDA Response

Initial Application

The MFDA and IPC are not certain of the intent of the comment that IPC may be engaged in the business of insurance. If the intent is to require IPC to qualify as an insurer and to be regulated by applicable insurance regulators at both the federal Canadian and provincial levels, the costs of establishment and operation of IPC will be very much higher than proposed. This intent would appear to be generally inconsistent with the observations by MFDA Members including the Bank-owned Dealers. As a technical legal matter it is proposed that IPC would constitute a fund offering discretionary coverage, but within reasonably defined parameters, and it would not, therefore, constitute insurance.

Revised Application

No Change.

2.4.3 Extra-territorial

It is unclear how the IPC will operate from an extra-territoriality perspective, as it appears that clients in other locations, both in and outside Canada, would be covered. This creates concerns about jurisdiction, since it is unclear on what basis, for example, the OSC indirectly compels mutual fund dealers to provide coverage for clients in Prince Edward Island or Quebec. It may also lead to the MFDA and the MFDA IPC having effective powers over mutual fund dealers in jurisdictions where it is not recognized. Finally, it would compel mutual fund dealers to pay for duplicative coverage, since other jurisdictions often have their own contingency fund or similar requirements. IFIC also requested clarification regarding IPC coverage to clients of mutual fund dealers in jurisdictions where the MFDA is not recognized. The Federation has sought clarification as to the co-ordination of the timing of coverage by IPC of clients in Quebec and the entering into of a mutual reliance arrangement between MFDA and Quebec regulators.

MFDA Response

Initial Application

The matter of extra-territorial operations of IPC do not appear to be of a substantive concern. CIPF offers coverage to customers of its members wherever they are located in the world. The requirement to belong to IPC would be mandated by MFDA itself and MFDA can impose whatever reasonable conditions of membership that it wishes. Similarly, IPC would be able to define limits to its coverage by jurisdiction and, for instance, in jurisdictions where MFDA is not recognized, it may choose not to provide coverage. However, neither MFDA nor IPC are satisfied that such a course of action is appropriate. The matter of Quebec, where MFDA is not presently recognized, is a separate matter because MFDA and the Bureau des services financiers as well as the Chambre de la sécurité financière have entered into a co-operative regulatory agreement which is pending approval by appropriate regulatory and governmental authorities.

Revised Application

Since the Initial Application, the Autorité des marches financiers has been established and taken over the functions of the former BSF and FISF (the Quebec protection fund). The Autorité has now approved the co-operative regulatory agreement which permits MFDA satisfactory authority with respect to its Members' affairs in Quebec regarding prudential regulation. IPC will not initially provide coverage for customers with accounts in Quebec at MFDA Members.

3. Corporate Governance

The Bank-owned Dealers felt that the governance structure of the MFDA IPC was deficient in that it was not appointed by MFDA Members but pre-selected. They noted that the IPC directors would also be the sole members and suggested that this would have the effect of limiting MFDA member input into the IPC's affairs. These

commentators were also concerned that they will have no representation on the IPC Board, but will be required to pay the majority of the assessments. They suggested that this is inconsistent with the CSA's criterion that the MFDA IPC should ensure " a proper balance between the differing interests of the MFDA Members participating in the MFDA IPC." The Bank-owned Dealers were of the view that this balance must be put into place prior to the approval of the IPC to enable the governance process to function properly.

MFDA Response

Initial Application

It is considered necessary that the operations of each of MFDA and IPC will have to be closely co-ordinated. At the outset it is proposed that MFDA would be responsible for the selection of IPC directors within the parameters adopted including the fact that the majority of the directors would be public and not industry representatives. The fact that this selection process would be made by MFDA under its proposed governance structure which is intended to be fully representative of the mutual fund industry and the public will ensure integrity in this process. In fact, the diversity of members is intended to be better represented through the new proposed governance structure for MFDA. A governance structure that bases representation on the amount of assessments paid is not considered fair or appropriate in the mutual fund industry.

Revised Application

The new governance structure of the MFDA was implemented in December 2003 and ensures that its Board is properly representative of its Members' diversity.

4. Coverage

The Bank-owned Dealers commented that the primary purpose of a contingency fund appears to have been overlooked in the Application because MFDA IPC will not provide coverage to assets of Members held in client name.

The Federation commented that RESP accounts should be treated as separate or combined according to whether they have the same beneficiary, not the same trustee.

PFSL commented that IPC should act quickly to reimburse client losses in the event of an insolvency and, if it did, it should receive preferential treatment in the remaining assets of the insolvent Member's estate.

MFDA Response

Initial Application

The observation that assets of a customer purchased through an MFDA Member but held in client name will not be covered by IPC is correct. On the other hand, cash

related to such purchases may be in the possession of the Member and the opportunity for Members and Approved Persons to deal with Member assets, even if they are held in client name, is relatively high. The common practice of Approved Persons holding powers of attorney from clients creates the functional equivalent of nominee holding for client name securities subject to the power of attorney. Furthermore, one of the purposes of MFDA IPC is to enhance the general integrity and confidence in the mutual fund distribution industry and all participants should share the cost.

The rationale for treating RESP accounts as being separate according to the trustee is that the trustee is always primarily responsible for the assets and is, in fact, the legal customer for the purposes of coverage. Accounts held in such manner are held in a separate capacity and circumstance and should be considered separate accounts.

In the event of an insolvency of a Member Part XII of the Bankruptcy and Insolvency Act (which relates to securities dealers and mutual fund dealers and came into force in 1997) does confer preferential treatment to customers of such dealers. The ability of IPC to act quickly invariably reduces total losses to customers and will, as a result, increase assets available to other creditors.

Revised Application

No Change. The Revised Application reflects that coverage is to extend to all cash, securities and other property held by an insolvent Member.

5. Fund Size

Two commentators questioned whether the proposed size of the fund is appropriate. One of these commentators noted that there is no discussion in the IPC Application as to how the predicted risk of loss, one of the factors considered in establishing the size of the fund, was determined. This commentator expressed concern that the risk of loss prediction may have been based on CIPF's experience, which could not be reasonably applied to mutual fund dealers given that CIPF members operate almost exclusively in nominee name. The other commentator recommended that the level of funding be reviewed at regular intervals, considering experience and potential for loss, and that the funding requirements be kept to what is necessary.

MFDA Response

Initial Application

As indicated above, there is no accurate, objective data or information with which to project the appropriate size of the fund of assets to be maintained by IPC. However, anecdotal evidence and experience is available and it is predicted that a fund of $30 million within five years would be a reasonable and adequate initial target. The CIPF experience was reviewed and it is of some help, but it was not considered by MFDA or IPC to be determinative of the needs and experience of the mutual fund industry. The

commentator indicated that the risk of loss of mutual fund dealers and securities dealers is quite different (with which MFDA and IPC agree) but it may be noted that the largest loss suffered by CIPF to date was approximately $35 million before insurance and other recoveries. In any event, the expectation is that the level of funding would be under annual review and will be changed as experience is gained. In addition, the prefunding principle of IPC does not preclude future assessments if, in the unlikely event, any individual or combined member losses exceeded funds available. In effect, the credit of all mutual fund dealers is at risk because all dealers are subject to assessment for any deficiency, and in that sense fund size is somewhat academic.

Revised Application

The initial fund size is to be increased to $30 million consisting of a combination of cash and a line of credit from an institutional lender. MFDA IPC has secured a commitment (subject to normal terms and conditions, all of which are expected to be satisfied) for $30 million from a Canadian chartered bank.

6. Funding and Assessments

6.1 General Comments

Several commentators expressed general concern over the cost of the IPC and the introduction of another fee for mutual fund dealers in light of the current state of the mutual fund industry. Commentators noted the decline in overall dealer profitability and expressed the view that every effort should be made to keep the cost of funding and administering the IPC as low as possible.

IFIC believes that the IPC should establish a funding formula that explicitly states how assessments will be made and how much money mutual fund dealers will be required to pay. The lack of a funding formula also precludes a cost benefit analysis of the IPC.

The Federation sought clarification as to how money in any existing provincial contingency funds will be handled and whether it will be incorporated into IPC or returned to dealers. The amount of money in such funds was also asked to be reported on.

MFDA Response

Initial Application

As indicated in the Responses to some of the comments that have been made in respect of the Application, both the MFDA and IPC are sensitive to excessive and/or duplicative costs in mutual fund dealer regulation, particularly because of the financial pressure that many securities and mutual fund dealers are currently experiencing. Both IPC and MFDA intend to minimize the cost of funding and administering the IPC to the

extent possible while still maintaining appropriate regulatory safeguards in the public interest.

The application proposes a specific funding formula including the basis of how assessments will be made and collected. In particular, the application states that the initial funding formula will be $30 per million of AUA to provide approximately $5 million and thereafter $30 per million of AUA (payable at $7.50 per quarter) for five years, subject to annual review. One of the reasons that the proposed funding formula is based on assets under administration is that such information is collected and available to members in respect of the calculation of MFDA's own fees. The matter of whether assets under administration is the most appropriate basis for a funding formula has been the subject of considerable debate and consideration. However it is the view of IPC and MFDA that at least in the initial stages of the development of IPC that that basis for funding formula is the most appropriate. It may be that as experience is obtained with IPC that other funding formula could be considered.

The CSA Members in provinces where there are existing contingency funds are reviewing the future of such funds.

Revised Application

The fund size, source of funds and assessment approach have been amended in the Revised Application.

6.2 Assessment Methodology

6.2.1 Assessments on Client Name Assets

The Bank-owned Dealers noted that since the IPC does not propose to cover client name assets, there will be little or no protection afforded to their clients who hold all their mutual fund assets in client-name. These commentators believed that the proposed assessment methodology based on assets under administration ("AUA") would be inequitable and unreasonable since they will be required to pay substantial assessments, yet neither they nor their clients will derive much benefit from the IPC because their client name assets are not covered. It was noted that the CSA criteria included the principle that assessments be equitably allocated and set by a process that is fair and reasonable. In addition, to the extent that Members perceive that MFDA IPC assessments are too costly, they may leave the MFDA and become investment dealers, ICPMs or other category registrants.

IFIC also commented that it is not reasonable to require dealers to pay assessments for client name assets that will not be covered by the IPC. IFIC stated that if all mutual fund assets are assessed whether covered or not, the IPC will be incongruent with the principles of CIPF, which does not levy assessments on client name assets. IFIC noted that this would also be inconsistent with section 5.1 of the Application, which states that the IPC's coverage principles will be similar in kind to those of the CIPF.

The Federation commented that the funding formula does not distinguish between nominee and client name assets; and that the assessments for IPC should be based on nominee name held assets which would be consistent with the principles of CIPF.

MFDA Response

Initial Application

The rationale for an assessment methodology based on AUA is explained in the application and the Responses to comments above. As indicated, client name business is not entirely risk free to customers as cash and assets (particularly securities subject to dealer or Approved Person powers of attorney) can be at risk in a dealer insolvency. The broader principle is that it is responsibility and in the interest of all distributors of mutual fund products to ensure that the investing public has confidence in their business and that protection is afforded to all customers. The benefits of a strong market with few barriers other than appropriate regulatory standards is shared by all dealers of whatever size and the investing public as well. In the circumstances, MFDA and IPC believe that the criteria of the CSA Members that assessments be equitably allocated and set by process that is fair and reasonable is satisfied. However, as the IPC grows and experience is obtained in the changing mutual fund business, other methods of assessment may be considered.

CIPF does not levy assessments on client name assets or, for that matter, any other assets. CIPF assessments are based on all revenues of members which include commissions in respect of client name business. In addition, the coverage principles to be adopted by IPC are generally similar to those of CIPF except that the range of products is to be limited by IPC.

Revised Application

MFDA and IPC will review at least annually the basis on which IPC assessments are made.

6.2.2 Non-Risk Weighted Methodology

The Bank-owned Dealers and PFSL Investments Canada Ltd. (“PFSL”) commented that the IPC assessment methodology does not allocate costs on the basis of risk. The Bank-owned Dealers indicated that the IPC assessment methodology should address the higher risks associated with such activities as holding assets in nominee form and the sale of prospectus-exempt products such as limited partnerships and hedge funds. Risk factors should include others than size. It was noted that other consumer protection funds such as CIPF, the Deposit Insurance Corporation of Ontario and the Canada Deposit Insurance Corporation employ a risk-weighted methodology.

The Bank-owned Dealers also observed the risk arising from losses of cash held by a Member will be limited because cash floats are typically quite small and client funds are promptly applied to the purchase of securities. Any cash is held in trust. As a separate but related point, it was noted that members of the IDA are not required to hold client funds in trust and, if MFDA IPC is created, the *quid pro quo*, and as a matter of fairness on equal access to capital, would be equivalent treatment for mutual fund dealers. This would require changes to provincial legislation and regulations.

In a separate submission, Scotia Securities Inc. ("Scotia") expressed concern that the IPC is based on the premise that the overwhelming proportion of products sold by MFDA Members will be mutual fund securities despite the fact that the Application states that there is little experience or empirical evidence regarding the extent of non-mutual fund business carried out by MFDA Members or the risk attached to such non-mutual fund business. Scotia stated that if a compensation fund is to be approved for MFDA Members, serious consideration should be given to restricting their securities activities to prospectus qualified open-ended mutual funds and debt instruments issued or guaranteed by government or financial institutions.

PFSL commented that the IPC AUA assessment methodology does not consider factors that would reduce the risk of insolvency such as high capitalization and strong internal controls. PFSL suggested that the MFDA, through its audit process, could assess each Member on an individual basis for the potential risk of loss to clients. Those Members assessed as having a low potential risk of loss could be given a rate reduction while those assessed as having higher risk could be assessed at a higher rate.

MFDA Response

Initial Application

The ability of MFDA and IPC to adopt a risk weighted methodology for assessments at the initial stages of IPC's development is not practical. In the first place, the wide range of business structures, capitalization, business activities and other factors present in MFDA members make it difficult to fairly weigh and assign risk. It is noted that CIPF's assessment structure is not risk based, with the minor exception of special assessments for regulatory capital non-compliance. In the second place, it is expected that the experience of IPC will be similar to that of CIPF in that most if not all potential losses will be as a result of or influenced by fraud. It is difficult in any kind of organization to assign appropriate risk weightings to the possibility of fraud. The MFDA and IPC have reviewed other consumer protection funds that cover fraud. A good example is the kind of compensation funds operated by provincial law societies in respect of lawyer fraud. The Law Society of Upper Canada, for instance, assesses its members a flat amount ($379 in 2001) per lawyer on the basis that it is not possible to predict where or when fraud in an organization such as a law firm – or securities or mutual fund dealer – may occur.

The fact that a high proportion of the business of mutual fund dealers is in prospectus qualified mutual fund products or other "safe" government and financial institution products does not necessarily reduce risk to a dealer or its customers. The product may maintain its value in an insolvency but the insolvency risk is still present. Moreover, fraud usually involves dealings in the most liquid assets that a customer has (i.e. cash, freely transferable government debt and money market funds).

Revised Application

MFDA and IPC will review at least annually the basis on which IPC assessments are made.

7. Advertising Related to IPC Coverage

The Bank-owned Dealers noted that the proposed amendments to MFDA Rule 2.7, which mandates advertising of the coverage provided by the MFDA IPC, could potentially be confusing and misleading to their clients since client name assets would not be covered. This concern was repeated in separate letters submitted by Royal Mutual Funds Inc. ("RMFI"), Scotia Securities Inc. and BMO Mutual Funds. RMFI proposed that client name assets be excluded from all aspects of the MFDA IPC and that appropriate disclosure language be drafted to clients as to the absence of contingency fund protection. In the alternative, RMFI suggested that coverage be extended to all assets held in client name, eliminating the need for disclosure explaining the differences in coverage dependent on holding status.

MFDA Response

Initial Application

The intention of the advertising requirements is to generally advise customers as to the existence of IPC coverage and the MFDA IPC official explanatory statement is specific that it is property held by the member that is covered. Customers should be advised, or be able to find out by inquiry, that if assets held by a member cannot be accounted for in the event of an insolvency as a result of the invasion of the account (to use SIPC terminology) compensation within the stated limits will be available. MFDA and IPC, as well as the relevant CSA Members, are conscious that the mandatory advertising be clear to customers and the experience during the initial period of IPC's operation can be monitored and any adjustments made to the requirements, if necessary.

Revised Application

The Revised Application refers to all cash, securities and other property held by a Member for a client as being covered by IPC, subject to eligibility and coverage limits. This approach minimizes client confusion as to what asserts are covered and, correspondingly, the advertising requirements in MFDA Rule 2.7 can be simplified.