

**1.1.4 OSC Staff Notice 31-712 Mutual Fund Dealers
Business Arrangements**

**OSC STAFF NOTICE 31-712
MUTUAL FUND DEALERS BUSINESS
ARRANGEMENTS**

The Ontario Securities Commission (OSC) has become aware of certain business arrangements between mutual fund dealers and investment dealers that enable clients of the mutual fund dealers to have a broad range of security holdings in their accounts, including non-mutual fund securities. Accommodating clients' needs to hold all their securities in one account poses problems for mutual fund dealers since their registration limits the types of investments in which they can trade and for which they can provide advice. Certain of these arrangements raise regulatory and investor protection concerns.

At the request of the Commission, the IDA and the MFDA have issued a Joint Notice instructing its members not to enter into any new joint service or omnibus account arrangements, and not to accept new clients utilizing any existing arrangements at this time. The OSC is also considering requiring mutual fund dealers and investment dealers to unwind these arrangements. Since this could have a significant impact on clients, as well as industry participants, the OSC is prepared to consider alternate solutions, if any, that would effectively address the regulatory and investor protection concerns that are raised by these business arrangements.

To achieve this result through the most appropriate course of action, we will engage the industry in a consultation process. As part of the consultation process, the Commission has sent an invitation and an issues paper to the members of the IDA and the MFDA for their input. A copy of the issues paper is published following this Staff Notice for information purposes.

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**MUTUAL FUND DEALERS BUSINESS
ARRANGEMENTS**

**ISSUES PAPER OF
THE ONTARIO SECURITIES COMMISSION
JUNE 2004**

EXECUTIVE SUMMARY

Dealers who are registered under the *Securities Act* (Ontario) in the category of mutual fund dealer are licensed to deal solely in mutual fund units and shares. However, the Ontario Securities Commission (OSC) is advised that investors increasingly prefer a single point of contact for all their financial needs, including both investment and insurance needs. In cases where clients would like to purchase products that the mutual fund dealers are not registered to trade (e.g. equity and fixed income products), mutual fund dealers have entered into arrangements with investment dealers to meet their clients' demands. The OSC has become aware of a number of business practices involving relationships between mutual fund dealers and investment dealers that appear to have developed in response to these pressures. Below we identify two specific types of arrangements and the regulatory issues they raise.

1. Maintenance of omnibus accounts for mutual fund dealers at investment dealers

Mutual fund dealers who offer self-directed registered accounts to clients will service these accounts in a number of ways, including holding clients' registered plan assets for safekeeping. If clients' assets are non-mutual fund securities, some mutual fund dealers have chosen to maintain an omnibus account at an investment dealer to hold the non-mutual fund securities. As the omnibus account holder, the mutual fund dealer is required to confirm or reject settlements of clients' orders in the non-mutual fund securities. The OSC has the following regulatory concerns:

- Clients' securities held in an omnibus account at an investment dealer are not covered by any investor protection fund.
- The nature of this type of arrangement places the primary responsibility for the clients' investments on the mutual fund dealer. Many clients would reasonably expect to receive advice on their entire investment portfolio. It also provides the mutual fund dealer with access to, and control over, the non-mutual fund securities of clients. Client expectations, along with access and control, increase the pressure for the mutual fund dealer and its salespersons to act beyond the scope of their registration.
- The mutual fund dealer may be trading in non-mutual fund securities by acting in furtherance of such trades within the meaning of the *Securities Act* (Ontario).

2. *Joint service arrangements*

Under these arrangements, a mutual fund dealer and an investment dealer jointly service a client who maintains an account at the investment dealer. The client may hold only mutual fund securities or a wide range of securities in his/her account. The following regulatory concerns have been identified:

- Division of responsibility to the client for advice and trade suitability is unclear.
- Responsibility for supervising the mutual fund dealer salesperson and any other personnel dealing with the client is unclear.
- There are potential gaps in liability to the client.
- The client may be misled to believe that his/her mutual fund salesperson is proficient to deal in other types of securities.
- The mutual fund dealer salesperson is acting on behalf of both the mutual fund dealer and the investment dealer.

The OSC recognizes that these arrangements may have developed from the industry's need to meet the demands of their clients. However, these arrangements are not in compliance with current regulatory requirements and raise the concerns identified above. As a result, the OSC is soliciting input from the industry on these issues in order to identify possible solutions that will address the investor protection concerns, while allowing the industry to meet clients' demands.

During the course of the review of these arrangements, the OSC became aware of other business arrangements that may resolve some of the regulatory concerns raised by omnibus account and joint service arrangements. These other business arrangements are briefly described in this paper.

Summary of Questions

Industry Trends

Question 1: Do you agree with the description of current industry trends? Are you aware of any other similar changes?

Question 2: Are there other relevant business arrangements that have developed in response to these industry trends? If so, please describe.

Omnibus Account Arrangements

Question 3: How are clients being properly served when only a portion of the portfolio held by the mutual fund dealer can be serviced by the mutual fund dealer?

Question 4: What actions can be taken to ensure that the mutual fund dealer salesperson is acting within the terms of his/her registration regardless of client pressure?

Question 5: What actions, if any, are being taken by mutual fund dealers to ensure that clients are aware of the lack of coverage on assets held by the mutual fund dealers at investment dealers? What actions should be taken in this regard?

Question 6: What controls or requirements could be put in place to ensure that mutual fund dealers are only trading and providing advice on mutual fund securities, while allowing clients to consolidate their holdings in one account?

Joint Service Arrangements

Question 7: Under our current regulatory framework, what actions, if any, can be taken to address concerns regarding supervision of salespersons in joint service arrangements? How can clear lines of responsibility of each of the dealers be maintained?

Question 8: How can we ensure that responsibility and liability of dealers in joint service arrangements to clients is clear?

Question 9: What controls, if any, could be put in place to prevent client confusion?

Question 10: Can you suggest any alternative solutions that would address the supervisory, accountability and liability issues that arise when salespersons act on behalf of two dealers?

Question 11: What changes, if any, would you support so as to allow the mutual fund salesperson to service the investment dealer account?

Alternatives Considered

Question 12: Referral arrangements require that clients have separate accounts at each dealer, instead of one consolidated account. The need for separate accounts may raise issues of convenience from the client's perspective; beyond this, are there any issues or consequences of referral arrangements that we should be aware of?

Question 13: If the MFDA/IDA introducer/carrier model contemplates two dealers servicing one client account, how can clear lines of responsibility (including supervision, accountability and liability) of each of the dealers be maintained? Alternatively, if this introducer/carrier model contemplates two dealers servicing two client accounts, how does this meet clients' needs? Furthermore, what actions can be taken to ensure that the mutual fund dealer salesperson is acting within the terms of his/her registration?

Question 14: Are you aware of any arrangements that would allow a mutual fund dealer to service its clients' need

for one consolidated account, yet do not raise these regulatory concerns?

Question 15: What are alternative solutions to the issues raised by the OSC with respect to joint service and omnibus account arrangements? Do these solutions require changes to the regulatory structure or requirements?

Question 16: Does a restricted dealer registration category continue to be appropriate in the current business environment where clients want to have one consolidated account and be serviced by one sales representative?

Question 17: If mutual fund dealers and investment dealers are required to unwind the joint service and omnibus account arrangements, what will the impact be to your firm's clients, as well as to your firm, and how long do you anticipate this would take?

A. INTRODUCTION

1. *Current Industry Trends*

There is increasing pressure for dealers and their salespersons to offer one-stop financial shopping to their clients. This observation is evidenced by the increased number of multi-licensed dealers and types of arrangements between different categories of dealers.

In order to meet the growing investor preference for a single point of contact for all their financial needs, many dealers and salespersons in the financial industry are licensed/ registered as insurance agents, mutual fund dealers and limited market dealers to offer as wide a range of financial products as possible to their clients.

As the number of investment products available is expanding and as clients become more sophisticated, they may demand a broader range of products, including equity and fixed income securities. This increases the pressure for mutual fund dealers to provide their clients with access to these products. However, Ontario securities law restricts the activities of dealers who are registered only in the category of mutual fund dealer. Section 98 of R.R.O., Regulation 1015 made under the *Securities Act* (Ontario) states that a mutual fund dealer is "a person or company that is registered solely for the purpose of trading in shares or units of mutual funds." In order to provide clients with access to equity and fixed income securities, or other securities in which they are not registered to trade, mutual fund dealers enter into arrangements with investment dealers, who are registered to trade in these products.

Clients also appear to want to consolidate their investments into one portfolio or account. This is especially true with registered accounts, when investors can take advantage of foreign content limit by consolidating their assets into a single registered account. As a result, mutual fund dealers offer and administer self-directed registered accounts. When clients want to hold non-mutual fund securities in these registered accounts, some mutual fund dealers enter

into arrangements with investment dealers to facilitate clients' trades in these non-mutual fund securities.

Question 1: Do you agree with the description of current industry trends? Are you aware of any other similar changes?

The OSC has identified a number of business arrangements between mutual fund dealers and investment dealers that appear to have developed to meet client demand for one-stop financial shopping and portfolio consolidation, but is particularly interested in the following business arrangements:

- Maintenance of omnibus accounts for mutual fund dealers at investment dealers, and
- Joint service arrangements.

Question 2: Are there other relevant business arrangements that have developed in response to these industry trends? If so, please describe.

2. *Regulatory Response*

The OSC is of the view that the above arrangements raise significant regulatory and investor protection concerns. The arrangements are inconsistent with our regulatory regime that allows a restricted mutual fund dealer category provided that such dealers' business is restricted to mutual fund securities. The OSC has discussed these arrangements and the concerns associated with them with both the MFDA and the IDA. In response, the IDA surveyed its members in December 2002 to understand which members have any of the business arrangements with mutual fund dealers. The MFDA and the IDA then conducted reviews of selected mutual fund dealers and investment dealers in 2003 to confirm the extent of these arrangements. It was found that these business arrangements are fairly widespread in the industry. As a result, the OSC has asked the IDA and the MFDA to instruct their members not to enter into any new omnibus account or joint service arrangements, and not to accept new clients utilizing any existing arrangements. The remainder of this paper outlines the regulatory concerns regarding these arrangements. This paper also describes some alternative business models that may address some of the concerns raised and/or may address clients' needs.

B. MAINTENANCE OF OMNIBUS ACCOUNTS AT INVESTMENT DEALERS

1. *Nature of Arrangement*

Many mutual fund dealers offer self-directed registered accounts to their clients. They will enter into an arrangement with a trust company to be the trustee for the registered accounts. The trustee will be responsible for registering the self-directed registered accounts in accordance with the *Income Tax Act* (Canada). The trustee will then delegate some or all of the following functions to the mutual fund dealers:

- Receiving clients' contributions into their registered accounts;
- Investing and reinvesting clients' funds according to their instructions;
- Holding clients' assets in their registered accounts for safekeeping;
- Providing statements of account and portfolio to the clients; and
- Reporting on the acquisition or holding of non-qualified investments and excess foreign property in the clients' registered accounts, and the consequences pursuant to the *Income Tax Act* (Canada).

In order to facilitate the above functions, a mutual fund dealer will enter into a separate arrangement with an investment dealer for the following purposes:

- When clients want to trade in non-mutual fund securities in their self-directed registered accounts, the mutual fund dealer will refer them to the investment dealer to open a delivery-against-payment (DAP) account with the investment dealer, usually in exchange for a flat referral fee or on-going commission splits. Clients will place orders for trades in non-mutual fund securities through this account, and will provide authorization to the investment dealer to transfer their non-mutual fund securities to the mutual fund dealer for safekeeping; and
- The mutual fund dealer will open an omnibus account in its name at the investment dealer. Non-mutual fund securities purchased by clients of the mutual fund dealer will be transferred from the clients' DAP accounts to this omnibus account for safekeeping.

2. **Regulatory Issues**

The following regulatory issues are identified with respect to the use of an omnibus account by a mutual fund dealer to hold clients' non-mutual fund securities:

a) *Pressure to act beyond the scope of registration*

Under this type of arrangement, the mutual fund dealer has primary responsibility to the clients with respect to their investments, and the investment dealer is generally relied upon only for the execution of orders in non-mutual fund securities. In most cases, it appears that clients only have a personal relationship with one sales representative – the mutual fund dealer salesperson. Clients are not assigned a specific investment dealer salesperson to assist them with their non-mutual fund securities transactions or portfolio. In most cases, the mutual fund dealer salesperson is also responsible for the financial planning needs of the clients.

Question 3: How are clients being properly served when only a portion of the portfolio held by the mutual fund dealer can be serviced by the mutual fund dealer?

Given the nature of their relationship with the mutual fund dealer, clients would reasonably expect advice from their mutual fund dealer salesperson with respect to their entire investment portfolio. Client pressure for more advice and financial incentive in the form of a fee may motivate mutual fund dealer salespersons to act beyond the scope of their proficiency and registration.

Question 4: What actions can be taken to ensure that the mutual fund dealer salesperson is acting within the terms of his/her registration regardless of client pressure?

b) *Investor protection fund*

In case of bankruptcy of the investment dealer, the omnibus account that is maintained in the name of the mutual fund dealer is not eligible for coverage from the Canadian Investor Protection Fund (CIPF). Conversely, in the case of the mutual fund dealer's bankruptcy, it is questionable whether the clients' non-mutual fund securities held in the name of the mutual fund dealer will be covered by an investor protection fund. The MFDA is currently considering whether its members should be covered by an investor protection fund established by the MFDA, i.e. the Mutual Fund Dealers Association Investor Protection Corporation (MFDA IPC), or whether they should be covered by CIPF. The MFDA IPC has proposed to cover only a client's mutual fund securities and related cash held by the mutual fund dealer. Details on possible coverage by CIPF are not available at this time since the MFDA is only at the early stages of discussion with CIPF.

Question 5: What actions, if any, are being taken by mutual fund dealers to ensure that clients are aware of the lack of coverage on assets held by the mutual fund dealers at investment dealers? What actions should be taken in this regard?

c) *Acting in furtherance of trades in non-mutual fund securities*

Since clients' non-mutual fund securities are held by the mutual fund dealer in its name, when clients place orders to sell their non-mutual fund securities, the mutual fund dealer is required to confirm or reject settlements of these orders with the investment dealer against the omnibus account. The acts of confirming or rejecting settlements are considered acts in furtherance of trades. The mutual fund dealer is acting beyond the scope of its registration when acting in furtherance of trades in non-mutual fund securities. Further, the OSC is of the view that such an arrangement provides the mutual fund dealer with access to, and control over, clients' non-mutual fund securities. This, coupled with client pressure discussed in point (a) above, provides added motivation for mutual fund dealers to trade or advise in non-mutual fund securities.

Question 6: What controls or requirements could be put in place to ensure that mutual fund dealers are only trading and providing advice on mutual fund securities, while allowing clients to consolidate their holdings in one account?

C. JOINT SERVICE ARRANGEMENTS

1. Nature of Arrangement

Joint service arrangements refer to arrangements in which mutual fund dealers and investment dealers jointly service clients who maintain accounts at the investment dealer. The OSC is aware of two scenarios where this type of arrangement is being used.

In the first scenario, an investment dealer relies on salespersons of an affiliated mutual fund dealer to service its clients' accounts, which are maintained and administered by the investment dealer. Under this joint service arrangement, the investment dealer would rely on the expertise of the salespersons of an affiliated mutual fund dealer to assist clients in recommending and placing trades in mutual fund securities. Clients would provide authorization to salespersons of the mutual fund dealer to transmit their orders in these securities to the investment dealer for execution. For other securities, clients would contact the investment dealer directly to place their orders. Clients are not required to open an account with the mutual fund dealer.

In the second scenario, a mutual fund dealer does not have the system in place to transmit certain mutual fund orders (e.g. third party mutual funds) to the relevant mutual fund companies or to maintain the necessary books and records required under current securities and self-regulatory organization requirements. As a result, the mutual fund dealer uses the system of an affiliated investment dealer to transmit client orders and to maintain client records. In these cases, the mutual fund dealer salespersons will open accounts for clients at the affiliated investment dealer. These clients will have accounts at the investment dealer, instead of the mutual fund dealer.

2. Regulatory Issues

The OSC has identified the following regulatory issues:

a) Supervision of salespersons by dealers and liability to clients

The current regulatory regime is based on the principle that a dealer will supervise and be liable to clients for the activities and conduct of its salespersons and ensure that the salespersons' activities are in compliance with securities legislation. The supervisory obligation of a dealer is explicitly laid out in section 3.1 of OSC Rule 31-505.

Under the joint service arrangement, it is unclear who is responsible for the supervision of the services provided by the mutual fund salespersons. Technically, the mutual fund dealer is required to supervise the activities and conduct of

its salespersons with respect to clients of the mutual fund dealer. In the joint service arrangements described above, however, the clients do not become clients of the mutual fund dealer. The investment dealer, on the other hand, is not required to supervise the activities and conduct of the mutual fund dealer salespersons, since they are not salespersons of the investment dealer, although it holds the client accounts. The joint service approach is inconsistent with the current regulatory regime, which relies on each dealer to supervise its sponsored salespersons.

Question 7: Under our current regulatory framework, what actions, if any, can be taken to address concerns regarding supervision of salespersons in joint service arrangements? How can clear lines of responsibility of each of the dealers be maintained?

Since the mutual fund dealer and its salespersons are not sponsored by the investment dealer, neither dealer may be held liable to clients for the misconduct of the mutual fund dealer salespersons. For example, if client investment instructions are not executed accurately, it might be difficult for clients to seek recourse from either the mutual fund dealer or the investment dealer.

Question 8: How can we ensure that responsibility and liability of dealers in joint service arrangements to clients is clear?

b) Client confusion

The OSC is of the view that by allowing mutual fund salespersons to "service" investment dealer accounts, clients could be misled to believe that the mutual fund dealer salespersons are registered and proficient to act on behalf of the investment dealers and to provide advice on all securities held in the account.

Question 9: What controls, if any, could be put in place to prevent client confusion?

c) Acting on Behalf of Two Dealers

By opening client accounts and providing investment advice on the trades in the account held at the investment dealer, these mutual fund dealer salespersons are acting on behalf of the investment dealer. This is not in compliance with subsection 1.1(1) of OSC Rule 31-501, which prohibits a salesperson from acting on behalf of more than one dealer.

Question 10: Can you suggest any alternative solutions that would address the supervisory, accountability and liability issues that arise when salespersons act on behalf of two dealers?

Question 11: What changes, if any, would you support so as to allow the mutual fund salesperson to service the investment dealer account?

D. ALTERNATIVES CONSIDERED

During the course of this project, the OSC was advised of other business models that may address some of the regulatory issues raised.

1. *Referral Arrangements*

The OSC understands that many mutual fund dealers have referral arrangements with investment dealers. Under these arrangements, mutual fund dealers will refer to investment dealers those clients who would like to trade in securities in which the mutual fund dealers are not registered to trade. In return, the mutual fund dealers will receive from the investment dealers a fee for the referral. Clients will open an account with the investment dealers for non-mutual fund securities, and have a separate account with the mutual fund dealers for mutual fund securities. Although referral arrangements do not satisfy clients' need for one consolidated account, they allow clients access to different products through different dealers.

Question 12: Referral arrangements require that clients have separate accounts at each dealer, instead of one consolidated account. The need for separate accounts may raise issues of convenience from the client's perspective; beyond this, are there any issues or consequences of referral arrangements that we should be aware of?

2. *Mutual Fund Dealer/Investment Dealer Introducer/Carrier Model*

The OSC is aware that the IDA and the MFDA are considering the possibility of an introducer/carrier model between MFDA members and IDA members in the event that the MFDA becomes a participating self-regulatory organization of CIPF. The IDA and the MFDA contemplate a model whereby the mutual fund portion of a client portfolio will be serviced by the MFDA introducer, and the non-mutual fund portion of the client portfolio will be serviced by the IDA carrier. The MFDA and the IDA have indicated that they will assemble a working group to consider such a structure. This model may address some of the regulatory concerns addressed in this paper, but it will not address all the regulatory concerns with existing omnibus account and joint service arrangements. In addition, this model is contingent upon the MFDA joining CIPF and receiving approval from CIPF and provincial securities regulators.

Question 13: If the MFDA/IDA introducer/carrier model contemplates two dealers servicing one client account, how can clear lines of responsibility (including supervision, accountability and liability) of each of the dealers be maintained? Alternatively, if this introducer/carrier model contemplates two dealers servicing two client accounts, how does this meet clients' needs? Furthermore, what actions can be taken to ensure that the mutual fund dealer salesperson is acting within the terms of his/her registration?

3. *Other Alternatives*

The OSC had considered requiring mutual fund dealers and investment dealers to unwind these arrangements immediately. However, the OSC recognizes that this would have a significant impact on clients, as well as industry participants. The OSC, therefore, is prepared to consider alternate solutions, if any, that would effectively address the regulatory and investor protection concerns raised by omnibus account and joint service arrangements. If no solutions were found, the OSC will require the dismantling of these arrangements.

Question 14: Are you aware of any other arrangements that would allow a mutual fund dealer to service its clients' need for one consolidated account, yet do not raise the regulatory concerns described in this paper?

Question 15: What are alternative solutions to the issues raised by the OSC relating to the joint service and omnibus account arrangements? Do these solutions require changes to the regulatory structure or requirements?

Question 16: Does a restricted dealer registration category continue to be appropriate in the current business environment where clients want to have one consolidated account and be serviced by one sales representative?

Question 17: If mutual fund dealers and investment dealers are required to unwind the joint service and omnibus account arrangements, what will be the impact to your firm's clients, as well as your firm, and how long do you anticipate this would take?