

INVESTOR ADVISORY PANEL

November 30, 2018

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission of New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

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Re: Proposed Amendments to National Instrument 81-105 *Mutual Fund Sales Practices* and Related Consequential Amendments

The Investor Advisory Panel (IAP) welcomes this opportunity to provide the Canadian Securities Administrators (CSA) with our response to its proposed amendments to NI 81-105 *Mutual Fund Sales Practices* and Companion Policy 81-105CP. The IAP is an initiative by the Ontario Securities Commission to enable investor concerns and voices to be

represented in its rule development and policymaking process. Our mandate is to solicit and represent the views of investors on the Commission's policy and rule making initiatives.

We commend the CSA for putting these proposals forward. At the same time, with regard to elimination of the deferred sales charge (DSC) option, we note Finance Minister Fedeli's recent statement that the government of Ontario does not support this proposal as currently drafted. We look forward to seeing the Minister's revisions and hope the CSA will afford all stakeholders an opportunity to comment on them in due course. Meanwhile, we submit below our views on the proposals in their present form.

Our comments are expressed with full understanding that the CSA and OSC are both currently engaged in projects to relieve regulatory burden, and we encourage regulators to eliminate unnecessary regulations and to streamline regulatory processes wherever possible. However, the IAP does not subscribe to a narrow conception of regulation as something inherently burdensome to business. There are many instances where necessary and appropriate regulation can and does act as a catalyst for business performance by contributing to the creation of market opportunities, or by influencing the implementation of business practices that improve efficiency and competitiveness.

We believe this to be true of the CSA's proposed client-focused reforms and these proposals as well. They represent smart regulations designed to eliminate practices that harm investors while at the same time creating opportunities for new and better business models to emerge and thrive by making financial advice more accessible and more economical.

Eliminating trailing commission payments to OEO dealers

We support the CSA's proposed prohibition on trailing commissions paid to, and accepted by, dealers that do not conduct suitability assessments (order execution only, or OEO, dealers). Since OEO dealers cannot give advice, they provide no ongoing service to justify being paid trailing commissions. The inappropriate and unwarranted practice of their receiving these commissions needs to be stopped.

We raise one caveat, however. Although the proposed Companion Policy urges fund companies to make available trailer-free versions of every mutual fund for OEO dealers to offer their clients, this option is not currently available for all mutual funds and may not come to pass for a considerable time, if at all. We recommend, therefore, that where no trailer-free version is available, OEO dealers should be permitted to sell the fund class that includes trailing commissions, subject to the following conditions:

- (a) The dealer must rebate to their client all trailing commissions paid to the dealer in respect of the client's fund units (less a small, reasonable fee to cover the cost of administering the rebate program); and

(b) When a trailer-free version of the fund becomes available, the dealer must arrange for conversion of their client's unit holdings to the trailer-free version at no cost to the client.

As a further matter, we note the underlying premise of the CSA's proposal is that trailing commissions must be earned through the provision of advisory services. We believe the CSA is right to hinge payment upon that premise but, correspondingly, there is a need for the CSA to specify a basic level of service that must be provided by non-OEO dealers in order to qualify for ongoing remuneration through trailing commissions. We urge the CSA to add that specification to its client-focused reforms.

Eliminating DSCs

We share the CSA's concerns about the harmful effects of DSCs; and while we look forward to seeing what alternatives the Ontario government may suggest, at present we agree with the CSA that elimination of the DSC option is the most appropriate policy response.

It is also a measured response, proposed after the CSA spent years carefully considering empirical research as well as submissions on the need to preserve investment choice and industry warnings about triggering an advice gap.

We observe that industry commentaries about the risk of an advice gap frequently overstate or oversimplify what occurred in one jurisdiction (the U.K.)¹, while disregarding positive outcomes experienced elsewhere (Australia).²

We note also that these same commentaries tend to gloss over the fact that an advice gap already exists in Canada – i.e., many advisors are disinclined or unable to service small accounts, despite current availability of the DSC option.

In addition, dire warnings about the impact of eliminating DSCs seem to disregard or downplay evidence that innovation has opened significant new avenues for serving small investors. Robo-advisory and hybrid firms are demonstrating increasing capacity to affordably meet the needs of mass-market investors, and this is being accomplished without reliance on the DSC option.

¹ Along with its ban on embedded compensation, the U.K. mandated significant proficiency upgrading. This led to stratification of advice services and some reduction in the number of advisors, though not a loss of service availability for those consumers willing to pay for advice. Moreover, the changes quickly reduced product bias in advisor recommendations and led to better outcomes for investors: see the December 2014 Post RDR Implementation Review by Europe Economics.

² A 2017 PWC report, Economic Impact of Banning Embedded Commissions in the Sale of Mutual funds, referenced a 2014 report by the ASIC which surveyed dealers and found that advisor numbers and the type of advice provided did not change as a result of FoFA. However, revenue structures for advisors changed. Retail accounts moved to direct-fee, hourly fee, or a combination of the two.

We also note that in a contemporary context it is difficult to view DSCs as an investor “choice” given the following realities:

- (a) A very large percentage of mutual fund investors admit they don’t know how their advisors get paid³ – so those investors cannot be said to have chosen the DSC as a payment option;
- (b) DSC use is inversely correlated to account size and the size of an advisor’s book of business⁴ – yet if DSC usage truly reflected an exercise of investor choice, we would expect to see more-or-less the same percentage of clients choose the DSC option no matter how large or small their accounts and no matter how large or small their advisor’s book of business; and
- (c) Nearly all front-end load funds today are sold with a 0% up-front fee⁵ – so it can no longer be said that investors “choose” the DSC option to avoid having to pay a large sum up-front.

All of this suggests that current use of the DSC option is not driven by investor choice but by some other factor – most likely advisor preference for, or acquired dependency upon, the up-front commission payment that DSCs provide. But neither of these factors constitutes a legitimate basis to overlook the harm caused by DSCs, and therefore, until we see whether Ontario’s government suggests a more effective policy response, we encourage the CSA to remain focused on eliminating the DSC option.

We appreciate this opportunity to comment on the proposals. Please let us know if you require any further information or clarification from us.

Yours truly,



Neil Gross, Chair
OSC Investor Advisory Panel

³ For example, the January 2017 report prepared by Innovative Research Group for the B.C. Securities Commission found that 36% of mutual fund investors are not familiar with the types of fees they’re being charged and 28% are not sure how their advisor gets paid. This latter percentage increases to 50% for small investors (accounts under \$50,000).

⁴ See the MFDA’s 2017 Client Research Report, which found that DSC and LL fund use differed significantly according to account size, falling from 48% for mass-market clients to 38% for lower mid-market, 30% for upper mid-market, and just 21% for HNW clients. Similarly, the Report noted that the incidence of DSC and LL use differed markedly based on size of the advisor’s book of business, falling in a linear fashion from nearly 60% of small books (under \$2 million) to just 17% of large books (over \$50 million).

⁵ According to Strategic Insight studies on cost of mutual fund ownership published by IFIC in 2012 and 2017, FE funds are sold with the front-end fee waived (i.e., 0% up-front) 98% of the time.