

INVESTOR ADVISORY PANEL

May 31, 2017

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, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
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Re: CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions

The Investor Advisory Panel is pleased for the opportunity to respond to *Canadian Securities Administrators (CSA) Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions*. The Panel is an initiative by the Ontario Securities Commission (OSC) to enable investor concerns and voices to be represented in its rule and

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

Executive summary

In our view, the CSA has produced a well written, thorough and evidence-based analysis of the negative effects of embedded commissions on investors. The Panel agrees with the CSA's main conclusions that "*embedded commissions raise conflicts of interest that misalign the interests of investment fund managers, dealers and representatives with those of investors*", that they "*limit investor awareness, understanding and control of dealer compensation costs*," and that embedded commissions paid "*generally do not align with the services provided to investors*."

Investors are entitled to independent objective and professional advice. However, all too often, they receive advice that is based not on what is the best or even the most suitable product for them, but on what is most enriching for their advisor or firm. Embedded commissions paid by product manufacturers to registrants who sell their products harm investors. CSA commissioned research has provided compelling evidence that embedded commissions and other forms of conflicted compensation do harm to investors. There is also ample evidence that prohibiting embedded commissions as the UK did in its retail distribution review results in less biased recommendations and better outcomes for investors.

The Panel therefore strongly supports a ban on embedded commissions paid by third parties on the sale of all securities, not only on mutual funds, non-redeemable investment funds and structured notes. We call for the prohibition of any compensation or embedded commissions that put the interests of firms and registrants ahead of clients or create a conflict of interest between firms or registrants and investors.

We also agree with the CSA that "*investors should be provided with a compensation model that empowers them and that better aligns the interests of investment fund managers, dealers, and representatives with those of investors*." However, we believe that all forms of conflicted compensation must preferably be addressed at the same time.

The *CSA Staff Notice 33-318 "Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives"* documents firm business models whose compensation and personnel policies are explicitly designed to incentivize and reward registrant behaviour that profits the firm and its employees at the expense of the client. The Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA) also conducted firm compensation practices reviews that provide compelling evidence of systemic conflicted practices which harm investors (*MFDA Bulletin 0705-C, IIROC Notices 16-0297 and 17-0093*). We call on the CSA to address these and all forms of conflicted compensation as well. Specifically, the Panel would like to see prohibited all forms of compensation practices, direct and indirect, that harm investors, beginning with those currently identified in the above-mentioned documents.

Part 1 - Embedded commissions must be banned

The Panel wholeheartedly supports a ban on embedded commissions paid by third parties on the sale of all securities and we ask the CSA to prohibit any compensation or embedded commissions that put the interests of firms and registrants ahead of clients or create a conflict of interest between firms or registrants and investors.

Indeed, there is much evidence that conflicted compensation harms investors. Here are just a few studies that prove this:

Professor Douglas Cumming's paper, "A Dissection of Mutual Fund Fees, Flows, and Performance," (2015) found that conflicted compensation in the form of sales and trailing commissions paid by fund companies, dealer affiliation and the use of deferred sales charge arrangements materially affects representative/dealer behaviour to the detriment of investor outcomes and market efficiency.

The OSC's 2015 "Mystery Shopping Report" found that, when first meeting with a representative, investors were likely to hear about products and services offered (78%) and discuss their investment goals (89%), but less likely to hear about product fees (56%), the risk/return relationship (52%) or registrant compensation (25%), making it difficult to comparison shop for financial advice, especially on important aspects such as fees and costs;

In 2015, mutual fund fee research prepared for the CSA by the *Brondesbury Group* looked at the extent to which the use of fee-based versus commission-based compensation in mutual funds changes the nature of advice and impacts investment outcomes. It did not find evidence that fee-based arrangements produce better outcomes for investors, however the paper found conclusive evidence that commission-based compensation creates problems that must be addressed. They found, among other things, that funds that pay a commission (sales loads and trailing commissions) underperform those that do not, whether looking at raw, risk-adjusted or after-fee returns.

A paper from the Executive Office of the President of the United States - *The Effects of Conflicted Investment Advice on Retirement Savings* (2015) – "found that conflicted advice leads to lower investment returns"; "savers receiving conflicted advice earn returns roughly 1 percentage point lower each year (for example, conflicted advice reduces what would be a 6 percent return to a 5 percent return)."

The evidence shows that embedded commissions and conflicted compensation harm investors.

The myth of the advice gap

The Panel would also like to take this opportunity to address the argument being made by some corners of the industry that a so-called "advice gap" will result if embedded

commissions are eliminated. We agree with the CSA consultation document which states that they “don’t anticipate a significant advice gap will exist” if embedded commissions are discontinued.

Aside from the above-noted research showing how destructive embedded commissions and conflicted compensation are for investors, there is ample evidence that advice is not being used by all Canadians at this time – in fact, just over 50% of Canadian investors work with an advisor according to the CSA 2016 Investor Education Survey.

Far from creating an advice gap, the banning of embedded commissions in the UK and Australia has led to positive strides forward. In the UK, The Financial Conduct Authority’s independent post-implementation review of the Retail Distribution Review (2014) found the ban had reduced product bias from advisor recommendations and led to better investor outcomes.

When it comes to an advice gap, let’s be very clear: no industry should address the concerns of people who do not want to pay for a service by charging them anyway and hiding the costs. This is not a healthy business model and it should not be acceptable in the Canadian investment industry. It is not transparent nor is it fair.

The only advice gap that needs to be urgently closed is the one between independent and compromised advice – the CSA is in a position to do that.

Panel responses to consultation questions

Q8. Are there other fees or payments that we should consider discontinuing in connection with the purchase or continued ownership of an investment fund security or structured note, including:

a. the payment of money and the provision of non-monetary benefits by investment fund managers to dealers and representatives in connection with marketing and educational practices under Part 5 of NI 81-105;

b. referral fees; and

c. underwriting commissions.

As noted below, the Panel is opposed to creating exceptions in these areas and supports discontinuing these payments.

Q11. If we were to discontinue embedded commissions, please comment on whether we should allow investment fund managers or structured note issuers to facilitate investors’ payment of dealer compensation by collecting it from the investor’s investment and remitting it to the dealer on the investor’s behalf.

Having fund managers collect fees on behalf of dealers is a concern because it will continue the lack of transparency that presently exists with respect to the payment regime. There

will also be additional costs for investors as securities are sold (and who gets to decide which ones are sold?) to pay for the fees as well as tax consequences for investors.

Q16. What types of payment arrangements are likely to result if this proposal is adopted? In particular:

- **Would the payment arrangements offered by dealers to investors differ based on investor segment? If so, how and why?**

The concern about payment arrangements is that most dealers will probably opt for fee-based compensation. For investors who tend to hold their investments for long periods of time with little trading activity happening, that would mean they could be paying for but not receiving corresponding services from the dealer.

IROC's review states that they found "*a bias on the part of most dealers towards fee-based accounts over commission-based accounts. Most dealers provide the highest possible grid payout to representatives for fee-based revenues. Our concern is that clients may be moved into fee-based accounts whether or not such accounts are consistent with the client's best interest. Certain dealers also stated that, given the attention placed on embedded commissions by the CSA, they are focusing on fee-based accounts as an alternative.*"

Q18. Given some of the changes we have seen in the industry over the past few years (fee reductions, introduction of DIY series, streamlining of fund series, automatic fee reductions increasing access to fee-based options etc.), what is the likelihood that the fund industry will transition away from embedded commissions without regulatory action? In particular:

- **Will the industry continue to transition away from embedded commissions if the CSA does not move forward with the proposal?**

The dependence of the industry on the embedded commission revenue stream would indicate it is unlikely to voluntarily do away with them.

Part 2 - Embedded Commissions are the tip of the iceberg

Embedded commissions are not the only compensation practices that are harmful to investors. In fact, they are just the tip of the iceberg. There are many other practices that must be addressed along with embedded commissions, most of which are outlined at length in the CSA's own Staff Notice 33-318 "Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives," which uncovered numerous examples of poor practices that leave investors underserved and at risk.

This CSA review, which was issued in December 2016, looked at practices at some of the largest firms in the industry both in terms of assets under management and number of approved persons. It considered both direct and indirect forms of compensation and incentives and outlined conflicts observed under each.

The report chronicles a host of troubling forms of compensation and incentive structures that show the extent to which these practices harm investors and erode their trust in

advice. Also prominent on the list of findings are misleading titles and monetary and non-monetary incentives designed to favour proprietary products, a practice used by integrated firms that own both distribution and asset management or product manufacturing. At integrated firms, staff can also be paid through compensation grids that provide higher payout rates for proprietary products or subsets of products.

According to the report, referral arrangements are, in fact, a significant problem. As the CSA report noted, the practice of referral arrangements:

"... may encourage representatives to search through their existing books of business to find those clients that could be sold the targeted product or service whether they need it or not. In the case of related party referral arrangements, it may encourage representatives to send their clients to another arm of their firm, even when third party product and/or service options may be more suitable. It may also encourage representatives to shift clients to more profitable business lines within the firm with little or no benefit to the client."

Given the CSA, MFDA and IIROC report findings, the Panel believes that embedded commissions are only one part of a whole spectrum of conflicted compensation practices that are systemic across the industry.

In addition to banning embedded commissions, we call on the CSA and OSC to immediately address the compensation structures and incentives referred to in CSA Staff Notice 33-318.

Part 3 - Embedded commissions – No exceptions approach

Given the CSA report findings that show how investors are harmed by conflicted compensation practices beyond embedded commissions, the Panel opposes the CSA's proposal to leave other forms of compensation unaddressed in its embedded commission ban, including:

- *referral fees paid for the referral of a client to or from a registrant*
- *dealer commissions paid out of underwriting commissions on the distribution of securities of an investment fund or structured note that is not in continuous distribution under an initial public offering*
- *payments of money or the provision of non-monetary benefits by investment fund managers to dealers and representatives in connection with marketing and educational practices under Part 5 of NI 81-105*
- *internal transfer payments from affiliates to dealers within integrated financial service providers which are not directly tied to an investor's purchase or continued ownership of an investment fund security or structured note*

The MFDA compensation review expressed concerns about referral arrangements: *"Compensation arrangements between referring parties that include bonus commissions or initial incentives to enter the arrangement are not specifically prohibited for referral arrangements as they are in a distribution agreement between a dealer and a manufacturing company. There is a risk that firms may look to structure sales arrangements as referral arrangements rather than distribution agreements to avoid certain regulatory requirements."*

Creating exceptions to the ban will only provide room for creative registrants to devise ways to overcome it. Staff Notice 33-318 amply demonstrates the inventiveness of the industry.

Part 4 – Final Recommendations

In order to address the harmful effects of embedded commissions and other conflicted compensation practices, the Panel recommends the following:

A ban on embedded commissions and a plan to address all forms of conflicted compensation – In line with our comments above.

Update and enforce NI 81-105, Mutual Fund Sales Practices – NI 81-105 came into effect in May 1998. This instrument is nearly 20 years old and needs to be updated to reflect the latest practices used to induce sales and must be extended to products beyond mutual funds. As of the date of the Consultation paper there has never been a single enforcement action of NI 81-105. Rules without enforcement are meaningless.

Title and proficiency reform – As the CSA report notes, misleading titles are a very real problem for investors. The CSA, IIROC and MFDA compensation practices reviews document instances of firms awarding titles as rewards for meeting sales targets, a clear abuse that misleads investors.

Titles must be supported by the appropriate level of education, including far more extensive ethics education and demonstrated competency in putting that knowledge to work properly.

Move ahead with Best Interest and targeted reforms – The Panel urges the OSC to move ahead with best interest and the targeted reforms outlined in *CSA Consultation Paper 33-404 - Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives toward their Clients*. This is more important than ever and the Panel supports the Ontario and New Brunswick Commissions as they move forward despite lack of support from other provinces.

In addition, we agree with the statement made in *CSA Consultation Paper 81-408* that “*The discontinuation of embedded commissions also complements the proposals outlined in CSA CP 33-404. Generally, jurisdictions that have enhanced the advisor’s standards and obligations have eliminated embedded commissions at the same time (as outlined in Appendix C) because they have recognized that these payments are one of the main obstacles preventing the advisor from working in the interest of their clients. Research suggests that these payments are a conflict that is very difficult to manage or mitigate, except through avoidance.*”

OBSI - Move ahead with the recommendations in the Independent Evaluation of the Canadian Ombudsman for Banking Services and Investments’ (OBSI) Investment Mandate which was completed in 2016 by Deborah Battell and Nikki Pender.

Rigorous and Regular Enforcement – The Panel strongly believes that effective enforcement of the entire investor protection regime is essential. Rules without

enforcement are useless. Equally important, dealers must always be held accountable and liable for their registrants' and agents' improper acts.

To reiterate, we call for the prohibition of any compensation or embedded commissions that put the interests of firms and registrants ahead of clients or create a conflict of interest between firms or registrants and investors. We also call for the prohibition of all forms of compensation practices, direct and indirect, that harm investors, beginning with those currently identified in the above-mentioned documents.

In addition, we ask regulators to take care in implementing any such rules in order to avoid inadvertently advantaging one industry sector over another or invoke other unintended consequences.

Collectively, the actions noted above would result in an investor protection regime that is more consistent with the G20 High-level Principles on Financial Consumer Protection and would vastly improve upon the existing regime -- and it would provide better financial results for investors.

It's time to move forward.

Yours truly,

Ursula Menke
Chair, Investor Advisory Panel