



June 9, 2017

Via email : comments@osc.gov.on.ca; consultation-en-cours@lautorite.qc.ca

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
Superintendent of Securities, Nunavut

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Me Anne-Marie Beaudoin
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Dear Sir / Mesdames:

Re: CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions

This comment letter is being submitted on behalf of the following RBC entities: Royal Mutual Funds Inc., RBC Global Asset Management Inc., RBC Dominion Securities Inc., RBC Direct Investing Inc. and Phillips, Hager & North Investment Funds Ltd. (collectively “RBC” or “we”). We are writing in response to the Canadian Securities Administrators’ (“CSA”) request for comment on Consultation Paper 81-408, published on January 10, 2017 (“Consultation Paper”). We appreciate the opportunity to provide further input on the issue of investment fund fees and, more specifically, to respond to the proposal to discontinue embedded commissions in Canada as outlined in the Consultation Paper.

I. Introduction

RBC's core purpose is to help clients thrive and communities to prosper. We offer advice, solutions and other resources to help clients meet their savings and investment goals at every stage of their lives. We offer a broad range of financial products and services to meet clients' diverse needs, which are accessible at their convenience whether in person, on the phone or digitally. We are committed to earning our clients' trust by building lasting relationships and aligning with their interests because we only succeed when we help our clients succeed.

At RBC, we fully support the principles of strong investor protection, market efficiency and competition. Our approach and business model have evolved in a manner consistent with the following fundamental beliefs, which remain consistent with our responses to earlier discussion papers related to this topic:

- mutual funds are an effective investment vehicle for all investors, particularly retail and mass affluent individuals,
- the total cost to investors of owning mutual funds in Canada is comparable with other developed markets¹,
- access to financial advice is valuable to investors²,
- investor choice is important; specifically, investors have the right and the ability to choose whether to seek financial advice or not, and to choose how to pay for that advice and service,
- transparent disclosure of the cost of investing in mutual funds is important, including what investors pay the fund manager and the dealer, and
- a competitive market, where businesses determine what client segments to pursue, what products and services to offer, and what fee options to make available, is the best policy option for clients.

We believe investors are well served in an environment that fosters competition, which is enabled by investors having access to sufficient, comparable information to make informed decisions. Given sufficient information, access to advice and choice, investors will choose the model that best suits their needs, and will reward market participants based on their ability to deliver value through investment solutions and how well they serve clients' needs. There is ample evidence that the Canadian mutual fund market is efficient and highly competitive with relatively low barriers to entry. In May 2017, Morningstar Advisor Workstation's database listed 1,340 new individual funds that have been introduced in Canada since January 2010. Several notable Canadian-based and large foreign fund companies have entered the retail fund market since 2008. Finally, Canadian mutual funds face direct competition from thousands of ETFs listed on both Canadian and U.S. exchanges as well as individual stocks, bonds and deposit instruments.

We are proud of the mutual fund business that we have built to help clients meet their financial objectives. In responding to client and advisor demands, market opportunities and regulatory changes, our focus is to create value and choice for our clients. We have expanded our mutual fund business from a single distribution channel to a multi-segment, multi-channel approach that offers Canadians

¹ Investor Economics and Strategic Insight, *Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios. A Canada – U.S. Perspective*, November 2012.

² CIRANO Institute, *Econometric Models on the Value of Advice of a Financial Advisor*, July 2012. Clients with advisors are more likely to start investing earlier, invest regularly, save enough, diversify and have a financial plan. These behavioural activities are core attributes to investing successfully.

choice in how they access mutual funds, whether they seek advice and how they may choose to pay for that advice. Our commitment to serving our clients is demonstrated by our:

- continued enhancement of the advice capabilities across our distribution networks, including increased availability and access to advice and our financial planning and wealth management services,
- emphasis on a portfolio approach to investing, with a focus on asset allocation and risk appropriate diversification. We have expanded the asset classes, geographies and strategies within our expertise to improve our ability to construct effective portfolios and address investors' needs,
- focus on delivering value through some of the lowest MERs in the market. We introduced Series D in 2007, to lower the costs of investing for DIY investors, and
- continuing to identify opportunities to simplify and lower fees. In 2016, we lowered management fees even further by eliminating our High Net Worth Series and moving to one low fee on every dollar invested.

Our concern with the CSA's proposal to ban embedded commissions is that it is a blunt measure for addressing the three key investor protection and market efficiency issues identified in the Consultation Paper and that it could produce the following unintended adverse consequences for investors:

- 1) **reduced access to advice and choice,**
- 2) **increased costs, and**
- 3) **increased complexity.**

Our view is that the three key issues would be better addressed by a combination of more focused changes that we describe in the last part of our submission (page 7).

II. Potential for Reduced Access to Advice and Choice

The investment fund industry is vital to the Canadian economy and to the financial futures of Canadian investors at all wealth levels who use mutual funds to generate income and grow their financial wealth. Mutual funds, and access to advice, have enabled Canadians with minimal capital to participate in capital markets and access professionally-managed, diversified investment solutions. As a result, mutual funds have become the most widely-held investment vehicle, accounting for 31% of Canadians' financial wealth held by 33% (4.9 million) of Canadian households.³

In a recently released report, the Mutual Fund Dealers Association of Canada (MFDA) has produced data⁴ showing that mass-market households comprise the largest segment of its members' client base and that they contribute 28% or \$177 billion of MFDA members' total assets under administration, which are almost entirely held in mutual funds. Similarly, 60% of the client accounts of Royal Mutual

³ Investment Fund Industry of Canada (IFIC) statistics as of 2015.

⁴ MFDA, *MFDA Client Research Project: A Detailed Look Into Members, Advisors and Clients*, May 23, 2017: 8.9 million households in Canada (56% of all households) are serviced by the MFDA advisors, 83% of which (7.3 million households) are mass-market households with financial assets of less than \$100,000.

Funds Inc. (RMFI) hold mutual funds that total \$25,000 or less, of which 23% of these clients are age 60 or older.

The Consultation Paper states that “*mass-market households make up the largest share of those that do not own investment funds*” and that “*investment funds are less popular than traditional savings vehicles with mass-market households*”. These statements understate the importance of mutual funds to mass-market Canadian households. The Ipsos Canadian Financial Monitor that the CSA references shows that millions of mass market Canadian households own mutual funds. In fact, according to the data, mutual funds are more popular than GICs. The data also highlight that too many mass-market Canadian households are reliant on chequing and savings accounts, which will not contribute meaningfully to their financial goals. We have witnessed substantial growth in investment savings by mass-market households over the past 20 years, but there is still significant room for improvement. Any actions that potentially limit their access to advice or discourage investment savings should be considered carefully, as this is the segment of Canadians most at risk of not meeting their financial goals.

In addition to investment-specific recommendations and overall portfolio construction, advice can include ongoing monitoring and rebalancing of a client’s investment mix, as well as retirement or goal-specific planning services. Numerous studies have confirmed the benefits to Canadians who work with financial advisors, including increased financial discipline, higher savings rates and larger asset balances at retirement. In a 2014 report entitled *Boosting Retirement Readiness and the Economy Through Financial Advice*⁵, the Conference Board explored the link between the use of financial advisors, retirement readiness and the country’s long-term economic growth potential. The report concludes that, “Overall, a scenario where savings are increased over the long term results in a large accumulation in savings, which Canadians can use to supplement their retirement incomes. It also has a positive impact on Canada’s potential economic output, which results in a permanent increase in income and profits in the economy.”

The CSA has acknowledged the possibility of an advice gap if embedded commissions were discontinued. However, it believes that such a gap could be covered by the use of online advisers (colloquially known as robo-advisors), the introduction of alternative compensation arrangements for clients for whom fee-based accounts may not be suitable and by allowing fund managers to facilitate investors’ payment of dealer compensation by collecting payments from the investor’s fund investment.

- While we agree that robo-advisors will be a service valued by some investors, we caution that it is unlikely to meet the expectations of all segments, particularly those who prefer their existing advice relationship. Projections on the adoption of robo-advisors vary considerably among studies⁶, although a common view is that millennials are more likely to use robo-advisors than seniors.

⁵ Antunes, Pedro, Alicia Macdonald, and Matthew Stewart. *Boosting Retirement Readiness and the Economy Through Financial Advice*. Ottawa: The Conference Board of Canada, 2014.

⁶ HSBC Bank plc commissioned Ipsos MORI to survey 12,019 people in 11 countries, including 1,001 in Canada. The results for Canada were published in *Trust in Technology Country Report – Canada* and the accompanying News Release, May 24, 2017: Only 7% of the Canadian respondents would trust robo-advisors to make their investment choices and 18% believe that computer programmes provide more accurate advice than human advisors. By comparison, a *BMO Capital Markets Future of Banking Survey 2017*, which had 550 participants (about 40% of whom were below the age of 40), indicates that “only 1 out of 20 respondents had ever used a robo-advisor, but 6 out of 10 expressed some level of interest in trying one” and that “1 in 3 would consider investing more than 10%

- The CSA suggests that alternative compensation arrangements could include various direct pay or flat fee arrangements. However, as we explain in the next section, such alternatives could result in higher costs and consequently may not be considered an option by many mass-market investors.
- Some fund companies already facilitate fee payments to dealers by redeeming fund units from fund holdings. However, this option is currently manually administered. Replicating this model on a mass-market scale would require industry-wide system enhancements and additional resources by both investment fund managers and dealers to administer the program, at substantial cost.

Other potentially negative outcomes of reducing choice include driving investors to conservative products (e.g. GICs) that may not generate the income they require and creating a systemic incentive that favours higher-cost insurance-based investment funds that would continue to have embedded commissions.

III. Increased Costs for Mass-Market Investors

Trailer fees paid to the dealer not only pay for advice but also cover other service costs for the benefit of clients. These include:

- enabling clients to transact and manage their mutual fund holdings through multiple channels, including in-person, with telephone representatives and via online and mobile platforms,
- account servicing, reporting and production and delivery of account statements and other communications,
- compliance with rigorous regulatory requirements, and
- providing enhanced account features such as allowing clients to invest as little as \$25 without a per-ticket trade commission at many dealers. Currently, 28% of RMFI clients invest regularly through pre-authorized contributions. Such features, in addition to Automatic Investment Plans, encourage Canadians to invest regularly without worrying about transaction costs. For example, 44% of all mutual fund purchases⁷ at RBC Direct Investing Inc. are done for amounts of less than \$500.

We are of the view that a ban on embedded trailers could harm investors by increasing costs and thereby limiting access to advice relative to alternative direct-pay-only models.

- An up-front flat-fee option is unlikely to be selected by clients, as the level of the fee required to cover the initial and ongoing advice, access and service costs would probably be seen as too high by most clients, especially those in the mass-market.

of their savings in a robo-advisor” (BMO Capital Markets, *The Crow's Nest: A Focus on Digital Wealth*, March 3, 2017).

⁷ Based on all mutual fund purchase transactions at RBC DI from March 1, 2016 to March 6, 2017.

- A fee-based account option would likely be the most economically feasible option for the industry. For some firms, this would be a new service that would require significant up-front investment. For dealers who currently offer fee-based accounts, the arrangements typically involve a percentage fee applied at the account level, rather than on the type of assets, and, in almost all cases, involve an account minimum. It is likely that a flat or tiered percentage fee at the account level would be costlier for clients than the existing standard trailing commission model, particularly for more conservative investors whose investments may be primarily in fixed income funds with lower trailer rates. Lastly, due to the costs associated with the administration of fee-based accounts, the minimum fee charge / account is unlikely to be eliminated.
- Many firms currently allow clients to invest as little as \$25 with no transaction-based commission, including the highly popular Automatic Investment Plans. Introduction of a transaction-based commission on these regular purchases to pay for non-advice services would make these transactions more expensive for clients. That is, even a nominal per-transaction fee charged to small periodic investments would amount to higher transaction costs due to the frequency of trading, as compared to the ongoing embedded commission option.

IV. Increased Complexity for Investors

Financial advice plays a crucial role in the lives of Canadians who face an increasingly challenging financial environment. Interest rates and financial literacy levels remain low. Disappearing employer-sponsored defined benefit plans are forcing more and more Canadians to take personal responsibility for ensuring their financial well-being in retirement. These challenges are recognized by government⁸ and securities regulators.⁹ Removing an option by which investors can easily access financial advice may lead investors to try a DIY approach to investing rather than pay for advice directly. The increased complexity of understanding and selecting suitable funds or other investment instruments is likely to produce sub-optimal returns for investors.

Under a direct-pay fee model, certain economies of scale are lost if fees are calculated and collected for each account, rather than across investors at the fund level. Further, investors would incur the added cost and complexity of reporting taxable gains or losses realized by redeeming units to pay fees. Errors in accounting for fees on personal tax returns may result in overpayment of taxes, penalties and/or audit costs. With embedded trailers, tax deductions are managed at the fund level for the benefit of all investors so that this risk is avoided. If embedded commissions are discontinued, the cost of account servicing would increase as dealers would face higher volumes of tax administration and reporting.

⁸ Final report of the Ontario government's Expert Committee to Consider Financial Advisory and Financial Planning Policy Alternatives, November 1, 2016: "From older workers who need guidance on how to plan for retirement and draw down their savings to younger workers who may have no workplace savings options at all, Ontarians will increasingly need and depend on receiving quality Financial Planning or Financial Advice."

⁹ In OSC Notice 11-777 – *Request for Comments Regarding Statement of Priorities for Financial Year to End March 31, 2018* ((2017), 40 OSCB 2579), the OSC recognizes changing demographics as critical to understanding investor needs and as a key driver of most investor-focused issues. "In particular, the need for retirement planning has increased, as the responsibility for saving and investing continues to shift from employer sponsored plans to the individual. The demand for accessible and affordable advice that meets individual investor needs is expected to increase."

For clients who invest only a portion of their assets in mutual funds (e.g. 5% invested in mutual funds within a segregated assets portfolio), it may not be suitable to move the entire portfolio to a fee-based account and incur additional ongoing costs. Requiring a client to open a separate, fee-based account for the mutual fund assets would be cumbersome for both the client and the firm. Client reporting would be fragmented and firms would be faced with a greater number of new accounts to administer for the same asset base.

For these reasons, we caution against regulatory action that may inadvertently affect investors' ability to obtain affordable advice or sever existing long-term advisory relationships. If the CSA were to proceed with the discontinuation of embedded commissions, there is a distinct possibility that many investors may choose not to seek advice. A recently released survey commissioned by AGF Investments Inc. found that 24% of the investors surveyed said that a change from indirect to direct compensation for advice and service would make investors like them less likely to seek advice from an advisor.¹⁰

As previously submitted in our comment letter to Consultation Paper 81-407 - Mutual Fund Fees, we firmly believe that preservation of investor choice should remain a key principle when considering any regulatory action. While we support regulatory efforts to address potential conflicts of interest between firms, advisors and investors, **we believe an alternative policy solution to the proposed discontinuation of embedded commissions would create better outcomes for Canadian investors.** Our alternative approach addresses the reality that no compensation structure is conflict-free and that the prohibition of one structure merely shifts the source of potential conflict to another compensation framework.

V. Proposed Alternative: Retain Embedded Commissions with Changes to Address CSA Issues of Concern

As an alternative to prohibition, we recommend the continuation of embedded commissions subject to certain changes.

While some of the changes have been considered by the CSA in the Consultation Paper, we think the combination of the changes together would address the CSA's three primary issues of concern regarding investor protection and market efficiency, while continuing to provide investors with the range of advice, access and service options that they use today.

Our alternative solution encompasses the following changes:

1. We propose enhanced disclosure and other means of improving investor awareness of typical trailer commission rates and any outlier rates to reduce the potential for conflicts of interest to arise from differences in compensation levels among similar types of investment funds.
2. We encourage the industry to offer a standard, low commission option (e.g. D series) for sale exclusively by Order Execution Only firms.
3. We propose that the industry take steps to discontinue deferred sales charge (DSC) and low load (LL) options to further reduce conflicts due to the variability in compensation options.
4. We encourage further review of the concept of disclosing full fund ownership costs to clients on an ongoing basis, in dollar value, as part of annual reporting on charges and compensation.

¹⁰ Gandalf Group, commissioned by AGF Investments Inc., *The Canadian Investors' Survey – An Opinion Research Study on Fees & Advisory Services*, May 30, 2017.

The following details support this proposal and are organized according to the three key issues raised in the Consultation Paper:

i. Conflicts of Interest

The underlying premise for the CSA's concern about the potential conflict of interest associated with embedded commissions is that fund manufacturers are using higher trailers to encourage dealers to favour their products over other funds with lower trailers. If trailer rates are the same among fund companies for the same type of funds, they are no longer a differentiating factor. In fact, research by the Investment Funds Institute of Canada (IFIC) has found that trailer commission rates are being reduced to standard levels or lower to the extent that relatively few funds offer rates that could be interpreted as an incentive. As at December 2006, 322 funds or 17.8% of all equity and balanced funds paid a trailer commission greater than 1%. As at April 2017, only 113, or 4.3% of all equity and balanced funds paid a trailer commission greater than 1%. That is, almost 96% of funds in these categories had a trailer commission of 1% or lower¹¹. There also appears to be a general standardization of trailer commission rates for money market funds at 0.15 – 0.20% and for fixed income funds at 0.50%.

We are not recommending that the CSA place maximum limits on trailer commissions rates, as we agree with the CSA's comment in the Consultation Paper that setting fee caps for investment products is not part of its traditional role. To the extent that fund companies do not voluntarily move their rates to a standard level, competitive pressure, disclosure and investor awareness should help to achieve this result. Similar forces would likely operate at the dealer level to encourage the adoption of standardized embedded commission options. To further advance this trend, the standardized trailer commission rates could be published on various websites, such as the Investor Education sites of the securities regulators and trade associations, and included in Fund Facts along with the actual trailer commission rate paid by the fund. These measures would enable the investor to discuss the reasons for any difference from the standard rate with their dealer representative and to make an informed decision whether to purchase the fund. Our expectation is that investor decisions and competitive pressures would eventually result in any higher-than-standard trailer commission rates converging with the standard rates.

In a similar way, removing DSC and LL commission options would prevent conflicts that may be created by large upfront commission payments versus smaller ongoing payments for service and advice.

ii. Limited Awareness, Understanding and Control for Investors

Awareness of fees has been improved by the current POS and CRM regulations which make fees and commissions highly salient and understandable to investors. The fee disclosures in Fund Facts documents would be simplified if DSC and LL options were removed and would be enhanced by including the standard trailer rate for comparison with the particular fund. Future enhancements to POS disclosure could further clarify overall costs and commissions levels, including a discussion about any difference from the standard trailer commission rate.

Clients' understanding of fees will be further enhanced by CRM reporting, which will continue to provide detailed cost and performance reporting in a manner similar to direct pay models. Further disclosure of

¹¹ IFIC research of all equity and balanced funds in Canada issued by prospectus, May 2017.

total MER costs would provide investors with full cost information and place trailers into context as part of the complete cost of the investment.

With no early redemption costs from DSC or LL options, investors would always be in control and have the choice to change their advice costs by moving to direct-pay or lower-cost options (e.g. Series D) without changing investments, realizing a taxable event, or incurring a redemption penalty (DSC or LL commissions).

iii. Alignment of Fees Paid to Value of Service and Advice

Direct-pay arrangements around the world provide market-based evidence that investors value the advice and service they receive from investment professionals. Furthermore, the value of advice is supported by other factual observations in Canada, such as:

- low financial literacy rates,
- increasing complexity of investment markets and savings programs (e.g. RSP, RESP, TFSA, RDSP),
- the growing trend of downloading financial responsibilities to individuals, partly through the elimination of employer-sponsored defined benefit programs, and
- the growth of direct-pay and discretionary offerings.

Numerous research studies support the role of advice in delivering value to investors through both tangible and intangible means.¹²

The recent enhancements to the disclosure of fees through POS and CRM2, supplemented by the additional measures we have suggested to increase awareness and understanding of trailer commissions, should enable investors to be better informed about the fees they are paying. We recommend that these measures be given an opportunity to support investors' decision-making process rather than taking the more extreme step of reducing the choices available to them.

VI. Conclusion

We believe our alternative solution would promote a fair, competitive and efficient market for investment products and advice. Canadians could continue to access a full range of investment options and freely choose between the wide array of advice and non-advice channels that exist today or that may emerge in the future.

Banning embedded commissions would remove an option for investors who prefer to obtain advice for a specific product at a much smaller threshold than would be required through a fee-based account. A ban would create a barrier for some investors who may encounter difficulties obtaining advice at a price they are willing to pay or sustaining current advisory relationships where they can consult a human advisor on a variety of financial matters. Also, some investors may be persuaded to move to investment solutions not affected by a ban on embedded commissions, which could result in clients owning more conservative options (savings vehicles) or higher-cost options (insurance strategies).

¹² For example, see Claude Montmarquette and Nathalie Viennot-Briot, *An econometric analysis of the value of advice in Canada*, CIRANO, July 2012, and *The Gamma Factor and the Value of Financial Advice*, CIRANO, August 2016.

By contrast, our proposed alternative solution would address conflicts of interest and simplify fee structures while reducing the potential for unintended consequences from regulatory arbitrage and supporting the efficiency and fairness of the market. In explaining our concerns about the proposal to ban embedded commission and our alternative solution, we have endeavoured in this letter to answer many of the questions listed in the Consultation Paper. The Appendix contains additional answers in response to other questions as elaboration of the points raised in our letter.

RBC is committed to promoting the affordability and accessibility of financial advice, products and services. In our view, the availability of high-quality advice, investor choice and innovation is in the interests of all investors. This includes a range of channels through which investors are able to access advice, which is a key element of a well-functioning market for financial advice. We urge the CSA to carefully examine stakeholders' feedback along with market-driven industry developments before deciding on next steps. To that end, we would be pleased to discuss our response with the CSA and provide additional information, as required, for the CSA's consideration.

Sincerely,

"Kirk Dudtschak"

Kirk Dudtschak
President & Chief Executive Officer
Royal Mutual Funds Inc.

"Doug Coulter"

Doug Coulter
President
RBC Global Asset Management Inc.

"Dave Agnew"

Dave Agnew
Chief Executive Officer
RBC Dominion Securities Inc.

"Rosalyn Kent"

Rosalyn Kent
President and Chief Executive Officer
RBC Direct Investing Inc.

"Mark Neill"

Mark Neill
President
Phillips, Hager & North Investment Funds Ltd.

Appendix – Responses to Consultation Questions

Question 3: Are there significant benefits to embedded commissions such as access to advice, efficiency and cost effectiveness of business models, and heightened competition that may outweigh the issues or harms of embedded commissions in some or all circumstances? Please provide data to support your argument where possible.

Yes, a significant benefit of embedded commissions is that they are automatically deducted by the fund against its taxable income for the benefit of all taxable investors. This is significantly more efficient, cost effective and less prone to error than direct-pay models where each individual investor must calculate and determine how to deduct their advice costs on their personal tax return each year.

The current disclosure mechanisms for embedded commissions provide a level of public transparency that is not available from most direct-pay fee schedules. In direct-pay arrangements it is more difficult for investors to know how the fees they pay compare to the fees paid by other investors.

Also, an embedded low trailer fee option (e.g. Series D) allows Order Execution Only firms to provide access and service to mutual fund investors with no transaction-based commissions.

Question 4: For each of the following investment products, whether sold under a prospectus or in the exempt market under a prospectus exemption:

- mutual fund
- non-redeemable investment fund
- structured note

should the product be subject to the discontinuation of embedded commissions? If not:

- a. What would be the policy rationale for excluding it?
- b. What would be the risk of regulatory arbitrage occurring in the exempt market if embedded commissions were discontinued for the product only when sold under prospectus?

We do not think embedded commissions should be discontinued. Investors should be allowed the freedom to choose whether they want to use a bundled or direct-pay model to pay their advisors. Current regulations ensure a high degree of disclosure of embedded commission levels paid both by individual investors and all other investors in a particular fund series. If embedded commissions are discontinued for some investment products but not others, the difference in compensation structure could incent market participants to favour certain products over others, such as segregated funds.

Question 5: Are there specific types of mutual funds, non-redeemable investment funds or structured notes that should not be subject to the discontinuation of embedded commissions? Why?

For the reasons given in our letter and in response to question 4, no type of mutual fund, non-redeemable investment fund or structured note should be subject to the discontinuation of embedded commissions.

Question 6: Are there other types of investment products that should be subject to the discontinuation of embedded commissions? Why?

RBC supports consistency of regulatory regimes across similar financial products to avoid opportunities for regulatory arbitrage. There are some indications that regulatory arbitrage is already occurring

between mutual funds and segregated funds, in response to the recent regulatory changes in the securities industry. (See article: Rob Carrick, *Despite high fees, popularity of segregated funds on the rise*, Globe and Mail, May 7, 2015.)

Question 7: Do you agree with the discontinuation of all payments made by persons or companies other than the investor in connection with the purchase or continued ownership of an investment fund security or structured note? Why or why not?

No, we do not agree that elimination of bundled forms of payments is necessary or desirable. We think Canadians should be free to choose between bundled and direct-pay models based on their needs and preferences.

Question 8: 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.

Why? What is the risk and magnitude of regulatory arbitrage through these types of fees and commissions?

No, there are no other fees or payments the CSA should consider discontinuing. Our view is that the general and product-specific education permitted to be provided to advisors under Part 5 – Marketing and Educational Practices of NI 81-105 is consistent with investor interests.

Question 11: 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.

To offer choice to investors, there may be value in a direct-pay model facilitated by investment fund managers. Expanded use of this compensation model, however, would require significant investments by both fund managers and dealers to transition from a paper-based to an electronic processing approach, with potential cost implications for investors. In contrast, embedded commissions are significantly more efficient to operate and do not require any new infrastructure.

Question 12: Based on a consideration of the data and evidence provided in this Part [Regulatory Impact], would a proposal to discontinue embedded commissions address the three key investor protection and market efficiency issues discussed in Part 2?

The data and evidence do not provide a high degree of certainty that discontinuation of embedded commissions would address the key issues. The Consultation Paper presents and interprets information in a way that seems to support a pre-determined conclusion. Supporting evidence is presented as overwhelmingly strong while negating evidence is either excluded, dismissed or judged to be not worthy of consideration. Also, new research has recently been produced by the MFDA, IFIC and other organizations, as cited in our comment letter, which should be considered as part of the consultation

process. In addition, little recognition is given to the many investors who are knowledgeable and choose to purchase and hold mutual funds with embedded commissions. It cannot, therefore, be concluded with certainty that a ban on embedded commissions would be more effective in addressing investor protection and market efficiency issues compared to the alternative we present.

Question 13: Are there other ways in which the CSA could address these issues that could be introduced in conjunction with, or separate from, the discontinuation of embedded commissions?

Yes, our proposed alternative is the combination of measures described in our letter, which, together, would more appropriately address the CSA's three primary issues of concern while minimizing the risk of unintended consequences and continuing to provide choice to investors.

Question 15: What effect do you think the removal of embedded commissions will have on investor experience and outcomes? In particular:

- **Will investors receive advice and financial services that are more aligned with the fees they pay?**
- **What effect will the proposal have on the growth of automated advice? Is this likely to be beneficial to investors?**
- **Is discretionary advice likely to increase in Canada as we have seen in the other markets that have transitioned away from embedded commissions and, if so, would this shift be positive or negative for investors?**
- **What effect will the proposal have on the growth of the online/discount brokerage channel and cost of fund products offered in this channel? Is this likely to be beneficial to investors?**
- **What effect will the proposal have on the cost and scope of advice provided to specific investor segments?**

We think that the removal of embedded commissions would have a negative effect on the ability of Canadian investors to freely choose the method of compensation that is best-suited to their needs and preferences. There is a very high level of fee transparency and regulatory protection provided to Canadian mutual fund investors today. Under this strong existing framework, Canadians can individually determine the extent to which their fees are aligned with the value they receive. In a free society, value in commercial transactions is an intrinsically personal and, at times, nuanced judgement that should not be dictated by anyone other than the individual.

Canadians should also continue to be free to choose whether to move to another form of advice, whether that be DIY, automated, fee-based, discretionary, online, face-to-face, digital or other based on their assessment of the value they receive. These choices, made freely under fair and transparent conditions, should determine how the market for advice develops.

Furthermore, Canadians who are happy with their existing embedded compensation arrangements should not be unwillingly forced to change to compensation formats that could lead to higher costs or formats that they may not be comfortable with. For example, elderly investors who have long-term relationships with their advisors and who do not feel comfortable moving to a direct-pay or online service model would be at risk of losing access to personalized advice to help manage the increasingly complex financial challenges of the later stages of life. Robo-advisors will likely be a valued option for certain investors. But other investors are likely to prefer the current level of personalized service they receive or, if the service model changes, forego advice altogether rather than use a robo-advisor.

Question 16: 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?**

Different delivery channels will evaluate payment arrangements according to the investor segment they serve and their business models. It is likely that a trend towards fee-based accounts would accelerate if the CSA proposal is adopted.

Question 17: Do you think this proposal will lead to an advice gap? In particular:

- **Which segments of the market are likely to be affected? Please consider segmentation by wealth, geography (size and location of community e.g. remote, small, medium, large), age, technological sophistication, the level of fund ownership across households, etc.**
- **Do you agree with our definition of an advice gap?**
- **Should we differentiate between an advice gap for face-to-face advice and an advice gap generally?**
- **What types of advice or services currently provided today would be most affected by the proposal?**
- **Are there any potential interactions between this proposal, existing reforms such as CRM2 and other potential reforms such as CSA CP 33-404 that may affect the size of any potential advice gap?**
- **How could a potential advice gap, face-to-face advice gap or financial service gap be mitigated?**
- **Do you think that online advice could mitigate an advice gap? If so, how?**
- **Do you think that the significant market share of deposit-taker owned and insurer-owned dealers in fund distribution in Canada will affect the size or likelihood of an advice gap to develop?**

Yes, the CSA proposal is likely to lead to an advice gap based on the CSA definition of the term [“the group of investors who cannot obtain the amount of advice they desire at the price they are willing to pay – today”].

If investors who currently prefer an advice delivery method based on an embedded commission model are banned from using that option, a segment of that population may disengage entirely from seeking financial advice. Those investors would lose the benefits of advice (such as higher savings rates and larger financial balances over time) that they would otherwise have had access to if allowed to continue using the embedded compensation model that was best suited to them.

While we cannot be certain of which segment would be impacted the most, the largest population of mutual fund investors are those with smaller investment balances. It would be reasonable to assume, therefore, that Canadians who stand to benefit the most from better savings habits and improved financial wealth over time would be the most likely to be negatively affected by the advice gap.

Online advice may help to address this advice gap, but the availability, viability and effectiveness of these systems has yet to be demonstrated in Canada or elsewhere on a wide scale. For this reason and given the personalization associated with face-to-face advice, some investors are unlikely to be comfortable with using online platforms, such as robo-advisors.

Question 18: 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?

These changes are clear evidence that the market is operating in an efficient and competitive manner. We expect the trend towards fee-based and discretionary accounts will continue. As new entrants continue to enter the market, some will introduce new advice delivery and fee options.

Question 19: How accurate is Figure 8 regarding the purchase options available to fund investors by channel, account size and firm type? In particular,

- **Do you see payment options and business models evolving at present?**
- **How are they likely to change over time if the CSA were to choose not to move forward with the proposal?**

For the MFDA category for Deposit-taker owned firms shown in Figure 8, please note that Royal Mutual Funds Inc. has introduced a fee-based account with a minimum of \$250,000.

With regard to IIROC-based deposit-taker owned firms, the chart shows fee-based accounts starting at \$500,000. Based on information indicated by the Investment Industry Association of Canada (IIAC) and on the fee-based accounts offered by RBC Dominion Securities Inc., the minimums are significantly lower than \$500,000. We support the IIAC's recommendation that the chart be amended for this channel as the current level shown does not reflect the mass and mid-market clients of deposit-taker owned firms with access to advice who could be adversely affected by the CSA' proposal.

Question 20: We note that the distribution of fee-based series is still relatively limited in Canada versus other markets. Are there obstacles (structural, operational, regulatory, investor demand, etc.) specific to Canada limiting the use of fee-based series by dealers?

Comparisons across jurisdictions can lead to incorrect reasoning because of the unique characteristics of foreign distribution platforms, series options and other factors that are also at play. For example, it is relatively common in some jurisdictions for fund managers to be required to pay dealers a platform fee or some other form of revenue sharing for their products to be offered to that dealer's clients. These kinds of payments to access a dealer's platform are prohibited in Canada. Regardless, fee-based accounts are widely available at dealers in Canada and we expect demand for fee-based series will continue to grow with the demand for fee-based accounts in this country.

Question 21: Please describe how discontinuing embedded commissions will affect competition and market structure and whether you agree with the analysis set out in Part 4? In particular:

- **Do you think the proposal will have an impact on the level of industry consolidation or integration? What about with respect to the concentration of mass-market investor assets held in investment products managed by deposit-taker owned firms?**
- **What are the likely impacts on investor outcomes and market efficiency of any potential consolidation?**
- **What opportunities and what challenges do you think the proposal would introduce for specific industry stakeholder groups?**

- Independent dealers?
- Independent fund manufacturers?
- Integrated financial service providers?
- Mutual fund dealers?
- IIROC dealers?
- Online/discount brokers?
- What is the likelihood and magnitude of regulatory arbitrage across similar financial products such as segregated funds and deposit-taker products?
- What would be the impact on dually-licensed mutual fund dealers and insurance agents?
- Will the proposal lead new, lower-cost entrants to the market? Why and how?
- Does the interaction between this proposal and the proposals set out in CSA CP 33-404 change your responses to the questions above and, if so, how?
- Will a transition away from embedded commissions reduce fund series and fee complexity, as we have contemplated?
- Do integrated financial service providers have an advantage in terms of their ability to cross-sell and cross-subsidize across business lines? If so, how?
- What are the potential effects on competition of the rise in online advice? Are these effects likely to be large and positive?

Dealers would likely adapt to the rule by adjusting their systems and client accounts to allow for direct-pay arrangements, if they have not done so already. Fund manufacturers would likely consolidate the number of series. Regulatory arbitrage would likely result in increased sales of segregated fund products, to the detriment of market efficiency.

Based on the current low barriers to entry, we expect new entrants (either low cost or otherwise) will continue to enter the market at a healthy pace regardless of whether the proposal is implemented or not.

With respect to the effects of online advice, those cannot be foreseen with any degree of certainty. However, the significant number of new online advice providers in the market today is further evidence that the market structure is efficient and competitive.

Question 27: How practicable are the mitigation measures discussed and how effective would these measures be at assuring:

- a. access to advice for investors,
- b. choice of payment arrangements for all investor segments, and
- c. a level playing field amongst competing investment products?

As the mitigation measures focus on new technologies, new business models, new educational programs and new attempts to liaise with other regulatory bodies, none of these measures have been tested or proven to work at an industry-wide level. Therefore, there is a risk that these measures would not be put into practice successfully within a reasonable timeframe.

Question 28: What other measures should the CSA consider to mitigate the above unintended consequences?

Please refer to the alternative option we have described in our comment letter above.

Question 29: Other than the potential impacts we have identified in Part 4, what other potential unintended consequences, including operational impacts and tax consequences, may arise for fund industry stakeholders and investors further to the discontinuation of embedded commissions? In particular:

- **Would there be a negative tax impact to investors associated with their payment of dealer compensation under direct pay arrangements? In particular, would the investor's payment of dealer compensation through periodic fund redemptions facilitated by the investment fund manager attract tax consequences? Please explain.**
- **To the extent a transition to direct pay arrangements results in the rationalization of fund series, could this rationalization attract negative tax consequences for investors?**
- **What, if any, measures, regulatory or otherwise, could assist in mitigating potential operational and tax impacts?**

There is the potential for investors under a direct-pay model to incur additional costs to correctly calculate and deduct investment costs in their personal tax returns. With embedded compensation, tax deductions are managed at a fund level for the full benefit of investors. With the move to direct-pay models, many investors would incur the added cost and complexity of reporting taxable gains or losses realized by redeeming units to pay fees. In addition, any errors in accounting for fees on personal tax returns may result in overpayment of taxes, penalties and/or audit costs.

Question 32: For each transition option, please tell us how your business (investment fund manager or dealer) would have to operationally change or restructure in terms of systems and processes and the related cost implications. Where possible, please provide data on the estimated costs.

- **Are there unique costs or challenges to specific businesses?**
- **What transition period would be appropriate?**
- **Should existing redemption schedules for DSC and low-load purchase options be maintained until the redemption schedule is completed, or discontinued at the Transition Date?**

Many fund manufacturers would need to make changes to series options and add new systems capabilities to allow for redemption of units to accommodate a new direct-pay model.

Dealers and manufacturers would need to develop new systems and processes to relay ongoing compensation rates to fund manufacturers and generate information related to fees to help clients with tax reporting.

All affected clients would need to be contacted and provided with education on the changes and agree to new payment arrangements or make other arrangements.

Existing DSC and low-load arrangements should be maintained until the DSC/low-load charges have expired.

Question 33: Which transition option would you prefer? Why? Are there alternative transition options that we should consider?

If the CSA ultimately decides to proceed with the discontinuation of embedded commissions, substantial investment would be required by firms to continue to serve clients' investments in mutual funds

through direct-pay arrangements. This would include a very large administrative effort to transfer clients fund holdings and engage with investors to explain such impacts as cost and tax. Our view is that transition option 1 – transition to direct pay arrangements within a defined time period – would be most suitable to effect the required changes.

However, we recommend that the impact of this change be mitigated by grandfathering current unitholders as long as they continue to hold or buy additional units of a particular fund. Grandfathered unitholders could choose at any time to switch to or buy different funds, which would not have embedded commissions.

Question 34: As discussed in Appendix B, the CSA did not retain the option of capping embedded commissions, either as a stand-alone solution to the key issues discussed in Part 2 or as an interim step toward an eventual discontinuation of embedded commissions. Should the CSA further consider using a fee cap as a transition measure? Why?

As outlined in our comment letter above, instead of a fee cap, our alternative approach proposes that enhanced disclosure and other means of improving investor awareness of typical trailer commission rates versus outlier rates and the discontinuation of deferred sales charge (DSC) and low load (LL) options would address the potential conflict of interest associated with variability of compensation rates.

Question 35: Please explain whether you think each of the initiatives discussed above [POS, CRM, CP 33-404, compliance reviews] will, either alone or in combination:

- **address the three investor protection and market efficiency issues and their sub-issues identified in Part 2; and**
- **address or not address any additional harms or issues that you have identified.**

The existing POS and CRM2 regulations make trailing commissions highly salient and understandable to investors. The Consultation Paper offers no conclusive evidence that a ban on embedded commissions would further enhance levels of investor awareness, value assessment and control over the services they receive.

Question 36: Are there alternative options or measures, whether regulatory or market-led, that could successfully address the three investor protection and market efficiency issues and their sub-issues identified in Part 2. If so, please explain.

Please refer to the alternative approach we have described in our comment letter.