Kenmar Associates

The Secretary
Ontario Securities Commission
20 Queen Street West 22nd Floor Toronto, Ontario M5H 3S8
Fax: (416) 593-2318
comments@osc.gov.on.ca

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ONTARIO SECURITIES COMMISSION NOTICE AND REQUEST FOR COMMENT

PROPOSED ONTARIO SECURITIES COMMISSION RULE 81-502 RESTRICTIONS ON THE USE OF THE DEFERRED SALES CHARGE OPTION FOR MUTUAL FUNDS AND

PROPOSED COMPANION POLICY 81-502 TO ONTARIO SECURITIES COMMISSION RULE 81-502 RESTRICTIONS ON THE USE OF THE DEFERRED SALES CHARGE OPTION FOR MUTUAL FUNDS AND RELATED CONSEQUENTIAL AMENDMENTS
https://www.osc.gov.on.ca/documents/en/Securities-Category8/rule_20200220_81-502-rfc-deferred-sales-charge-option-mutual-funds.pdf

Kenmar Associates is an Ontario-based privately-funded organization focused on investment fund investor education via on-line papers hosted at www.canadianfundwatch.com .Kenmar also publishes ***the Fund OBSERVER*** on a monthly basis discussing investor protection issues primarily for investment fund investors. Kenmar are active participants in advocating for regulatory reform. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused investors and/or their counsel in filing investor complaints and restitution claims.

Kenmar do not appreciate this "opportunity" to consume valuable investor protection time on a politically induced initiative. We do not intend to divert our scarce resources providing a fulsome Comment letter. Talk about regulatory burden. We refer the Ontario MOF to read our previous submissions and the volumes of independent, empirical research that are readily available on the harm caused by the DSC sold mutual fund. Or the Honourable Minister may choose to talk to the CSA as to why they banned the sale of DSC funds in the rest of Canada.

Normally, an OSC Consultation involves responding to proposals to increase investor protection. Over the past decade Kenmar have participated in well over two dozen such consultations and Roundtables. This consultation is uniquely different - it attempts to obtain feedback from respondents on how best to retain the toxic DSC sold mutual fund- an objective of the Ontario govt., not one of the "old" OSC. The goal of the consultation is not to improve investor protection- it is to minimize investor harm (in OSC words "mitigate negative investor outcomes"). **It is akin to improving the working conditions of slaves instead of banning slavery.**

There is no evidence or empirical research to back up the govt. driven proposals except an edict from Ontario's Government to retain this unsavoury compensation

method. The only supporters of the DSC are Firms and salespersons that benefit from the outsized front-loaded payment scheme. **It is bad enough for Ontario investors to pay more for conflicted advice but to pay for it in advance and imprison them for up to 3 years amounts to financial assault.**

While we would obviously prefer a total DSC ban, we reluctantly agree with all the restrictions delineated in the Consultation paper but feel additional restrictions and caveats should be considered in order to contain possible investor harm. These provisions include but are not limited to:

- The redemption fee schedule in Fund Facts should be printed in **BOLD** type
- Put a cap on the upfront sales commission, say 3% (prevailing rate now 5%); Creative Fund manufacturers may increase the trailing commission rate so that salesperson sales motivation remains high
- A rule that would permit clients to redeem the fund redemption fee -free if the fund's objective(s) is materially changed or it is merged with another fund with a higher MER or different mandate
- A rule that clients should not be sold DSC money market funds as they are intended to be short term parking spots for cash **;** switches into such funds would not be unacceptable
- Put a cap on dealer switch fees for DSC (and all) funds of say 0.25% **(**A common charge is "up to 2%" per many Fund Facts documents)
- A requirement for DSC (and all) mutual funds to auto-convert to lower cost A Series funds when the redemption schedule has expired
- Require Firms to have written policies on fee disclosure; procedures to test whether disclosure was provided to clients in cases involving significant redemption charges; and proper training for both salespersons and supervisors on the disclosure requirements.

We considered the inclusion of a requirement for the client to sign a redemption schedule acknowledgement form (based on an idea by Primerica https://www.osc.ca/documents/en/Securities-Category8-Comments/com_20181213_81-105_primerica-financial-services.pdf) but discarded it as it is inappropriate in dealing with unsophisticated clients who may not be able to provide informed consent.

It is our understanding that the proposals do not eliminate early redemption penalty payment in the event of unitholder death but do eliminate payment in cases of permanent disability and critical illness.

In addition to protection of clients over 60 years old, there should be restrictions on the type of clients to whom a DSC fund can be sold. These are:

- Vulnerable clients as defined by the U.K. Financial Conduct Authority
- Retirees , recent immigrants , veterans
- Clients who are drawing income immediately or within the DSC schedule (may result in DSC fees being charged if amount withdrawn exceeds the "fee-free units").

- Clients with a large debt load
- Clients with a drug addiction or are institutionalized

Kenmar recommend that OSC Guidance include a provision that dealers should not be permitted to circumvent regulatory intent – the $50K account cap-by opening multiple client accounts.

Kenmar recommend that OSC guidance be provided that Firms should not utilize commission grids or compensation plans that bias sales towards DSC mutual funds.

We recommend the term **"time horizon**" be defined in plain language and that that standardized definition be incorporated into Firm KYC / account forms, rules and processes.

There should be plain language disclosure in Fund Facts and by the salesperson as to whether the 10% redemption-free units refers to the current value or original costs of the mutual funds.

The proposal of creating a separate series for DSC funds is wholly appropriate. This should result in lower MER's for standalone, no-load / FEL sales charge series, a direct benefit for millions of Ontario investors. It has the benefit of basic fairness to all those investors who should not be paying for the amortization of the upfront sales commission payment and it increases the MER by about 20 bps thereby presenting the DSC fund's true cost absent the subsidization. The salesperson would then have to justify the sale of a more expensive DSC fund with redemption restrictions over a lower cost A series no-load fund (or a FEL fund with 0% FEL) with no redemption restrictions. Any conflict-of-interest would need to be disclosed and mitigated per prevailing MFDA and IIROC Rules. Investor advocates could not ask for a better solution other than an outright ban on DSC sold funds. The proposal is entirely congruent with the dealing honestly, fairly and good faith provisions of the Ontario Securities Act.

While a definite positive of the proposal is the ban on cross-subsidization, a huge negative of the proposal is it essentially limits sale of the expensive DSC option to households with smaller accounts, those struggling to save for their retirement or for their child's education.

We highly recommend an implementation date much earlier than more than 2 years away. The faster these changes can be implemented, the better. Ontario has specifically chosen not to harmonize with the rest of Canada so we don't see any rationale for the implementation date to harmonize with the CSA date for prohibition. This will have the advantage of curtailing DSC sales volume which could cause some fund manufacturer's to close their DSC fund series ahead of the June 1, 2022 date. That would be a good thing for retail investors as the volume of 6 year redemption schedule mutual funds on the market will decrease. (During the CSA designated transition period leading up to June 1, 2022, dealers will still be able to sell regular DSC funds and their redemption schedules will run to their conclusion

meaning that toxic 6 year DSC funds will be in client accounts in Ontario until 2028!).

As regards regulatory exemptions, Kenmar respectfully request intervenor status if any exemption request is put forward that would relax the proposed/final rules in content or implementation timing.

On pg. 60 of the CSA release on Client-Focussed Reforms https://www.osc.gov.on.ca/documents/en/Securities-Category3/ni_20191003_31-103_reforms-enhance-client-registrant-relationship.pdf we find this DEFINITION: *"trailing commission" means any payment related to a client's ownership of a security that is part of a continuing series of payments to a registered firm or registered individual by any party*. This suggests that the trailing commission does not have any particular purpose other than to reward dealers for sales (and/or shelf space).Specifically, it does NOT state that the trailing commission is for unique services or personalized advice. What impact will this have on a DSC fund unitholder after the upfront sales commission has been paid? Will there be a need for the client to sign a separate services and advice Agreement?

A May 2017 MFDA research report found that households with less than $100K to invest held 42% of assets in DSC funds while those with over $500 K held just 17%. As households with less than $100K in investable assets are less likely to be eligible for fee-based accounts, they are an attractive target of DSC fund salespersons (Proprietary funds sold at bank branches are not sold on a DSC basis; most funds sold today are actually 0% FEL or no-load). DSC sold funds are generally more expensive than mutual funds that do not carry a provision for the recovery of the 5% upfront payout to salespersons embedded in the management fee. **This suggests that investors of modest means based in Ontario could have their life savings impaired by fund salespersons recommending DSC mutual funds.**

A July 2019 Report by the OSC's own Investor Advisory Panel ***A Measure of Advice: How much of it do investors with small and medium portfolios receive?*** *A Measure of Advice: How much of it do investors with small and medium-sized portfolios receive?* points to some serious issues. This survey of 3,000 Canadians shed light on the nature, scope and extent of investment advice that small and mass-market investors currently receive from their investment advisors. The survey results indicate that, in many cases, basic financial planning concepts are not addressed in the advice provided. For example, nearly a third (31%) of those surveyed were unable to say their advisor ever talked to them about concepts such as planning for retirement, for education, or for buying a home. 49% of mass-market investors said their advisor spent less than an hour, in total, communicating with them during the past year or didn't communicate at all. **For small investors, the figure is 68% (less than an hour p.a. or no contact at all).**

It is ironic that the OSC is engaged in this time-consuming Consultation when it has already agreed, along with the rest of the CSA, to the so-called Client-Focussed

Reforms - reforms that are intended to raise the standard of conduct of the provision of financial advice. We include Appendix 1, our work on the CFR and DSC and their interaction. Any positive correlation between enhanced salesperson conduct and DSC selling is purely coincidental. We interpret the CFR requirements, which take effect Dec.31, 2020, as making it exceedingly difficult, if not impossible, to justify a DSC recommendation. The selling of a DSC sold mutual fund is as far from professional conduct as one can get.

Given the high level of conflicts-of-interest in a DSC sale, Kenmar **recommend that there should be a requirement that a registrant maintains documented evidence of the process used to collect and analyze the KYC information to determine what product is in the best interests of clients.** Unless there is a rule, dealers can let their Dealing Reps ask whatever questions they want as long as the KYC form is filled out. But what questions were asked to determine time horizon for example? In our experience, the biggest systemic problem relating to unsuitable advice is improperly assessing KYC (It's hard to figure out what happened after the fact if there is no documentation of what was asked). This record would make complaint and OBSI investigations much easier.

To help prevent harm we highly recommend that the OSC publish a Checklist for DSC investors - see sample at http://www.canadianfundwatch.com/2018/ and an update on Fund Fees like Mutual Fund Fees from the MFDA https://mfda.ca/wp-content/uploads/IB-Sep2018-1.pdf A Checklist is absolutely essential given that some Firms may use the transition interval as a last opportunity to turbocharge 5% DSC sales .In fact, we urge the OSC to issue an Investor Alert NOW to help prevent further mis-selling

Kenmar also recommend that whatever restrictions are ultimately imposed on DSC sold mutual funds in Ontario should also be imposed on DSC–sold Segregated funds by working in close collaboration with the FSRA. This will help contain regulatory arbitrage in Ontario. The trade Association for the investment industry, the IIAC, agrees with this position. Per their Comment letter, they stated "The IIAC supports the development of regulatory proposals that create a level playing field with non-securities financial products. We encourage the relevant regulators to work collaboratively to address this issue and avoid any risk of regulatory arbitrage."
https://iiac.ca/wp-content/uploads/IIAC-CSA-Proposal-81-105-OEO-and-DSC-Dec-13-2018.pdf

As usual, we stress the need for effective supervision, compliance and enforcement if the desired results are to be achieves.

Kenmar appreciate the extraordinary difficult conditions under which this consultation Paper was prepared. We commend OSC Staff for attempting to salvage some of the regulatory intent that an outright DSC ban would have provided.

We hope this abbreviated Comment letter is sufficient for the once independent OSC to inform their political overlords that investor advocates want nothing less than a prohibition of DSC sold mutual funds (and Segregated funds).

See APPENDIX 2 for our **Message to the Government of Ontario.**

We urge the OSC to publicly post this Comment letter as soon as possible so others may see our position on DSC.

Please do not hesitate to contact us if there are any questions.

Sincerely,
Ken Kivenko, President
Kenmar Associates

cc Honourable Rod Phillips, Minister of Finance (Ontario)

APPENDIX 1 CFR- DSC interaction

October 23, 2019

Client focussed reforms (CFR) and the sale of the DSC Mutual fund

A Desk Manual for Registrants

Under new CFR rules, registrants are required to (a) address material conflicts-of-interest in the best interest of the client, (b) put the client's interest first when making a suitability determination. The CSA expects that CFR will result in a new, higher standard of conduct across all categories for registered dealers and advisers and their representatives. Fund salespersons will need to demonstrate that any recommendation is based on the fund's quality without influence from any third-party compensation associated with the fund.

The rule changes also include explicit requirements relating to registrants' obligation to 'Know Your Product'. This means that registrants must take reasonable steps to understand the securities that they purchase, sell or recommend to a client, including the impact of the initial and ongoing costs associated with acquiring and holding each security, sufficient to enable them to make a suitability determination that puts the client's interests first.

A salesperson exhibiting professional judgement and conduct is expected to disclose material facts related to fund series conflicts to clients before the sale. Specifically, the *existence* and effect of different incentives and resulting conflicts.

- The fact that different fund series are available and that different fund series of the same fund represent the same underlying investments.
- How differences in sales charges, transaction fees and ongoing fees could affect a client's investment returns over time.
- The fact that a salesperson has financial interests in the choice of fund series that conflict with the interests of its clients.
- The fact that early redemption penalties may be incurred if the fund is sold before the redemption schedule has expired.

Such forthright disclosure should provide a reasonable basis for a retail investor to make an informed decision on the recommendation provided, a recommendation that must be in the client's best interests.

Under CFR, the presence of embedded commissions is considered a material conflict that has to be resolved in the client's best interest .A DSC series fund is the ultimate in embedded commission products providing a 5% upfront payment to the dealer, a portion of which is shared with the fund salesperson. How could a salesperson recommend an actively-managed DSC fund and argue it is in the client's best interest when making a recommendation under CFR?

This document provides the enhanced retail investor expectations for registrant conduct.

Given the plethora of low cost, no-load funds by banks, Vanguard and others, the existence of economical Robo-advisors and even low MER actively- managed ETF's, the old worn arguments about the lack of DSC alternatives creating a regulatory environment where the cost of servicing modest investors becomes prohibitive, or where these investors cannot find a salesperson to service their needs, should be disqualified as self-serving hype. In the CFR environment, salespersons, supervisory and compliance staff are expected to use their professional judgement to ignore such unsubstantiated claims and approve only recommendations that are in the best interests of clients.

There are some Firms and individuals that make the false argument that the DSC schedule helps keep clients invested during market downturns, thereby making a DSC fund transaction in the client's best interests. The truth is that there is no published independent research confirming that this argument is correct or even relevant. Furthermore, the redemption schedule may deter an investor from investing in lower cost, superior funds or paying down debt. It is the obligation of the salesperson to educate clients and use professional judgement to advise them during turbulent times, not to depend on punitive redemption penalties to keep them invested. Professional Supervisory and compliance personnel are expected to disavow such self-serving arguments, if the client's interests are to come first. In tacit agreement with this line of reasoning, many responsible investment dealers have already removed the DSC as a fund sales option.

With the DSC model, the up-front compensation is financed by the investment fund manager and paid for through a reduced trailing commission paid to the Firm, and

in turn, the salesperson. This places the Firm as well as the salesperson in a conflict-of-interest. If supervision or the branch manager's compensation is dependent on sales production, they too are in a conflict-of-interest. In such circumstances, the CSA expects Firms to address this conflict in the best interest of clients by implementing policies and procedures sufficient to mitigate the risk to clients' interests and to closely monitor for compliance with these policies and procedures. CFR dictates that such a sales transaction should be avoided if the client's best interests cannot be demonstrated to come first.

Cost is now an explicit suitability factor. With a comparable front-load series of the fund, the prevailing front load is effectively 0% so it needs to be considered for recommendation even if the MER for both series are identical. The salesperson also has to look at comparable funds that are lower MER (no load/non- DSC) and recommend the one that is in the client's best interests. Salespersons must be prepared to justify any suitability determinations where DSC sales are recommended and include higher cost and/or contain redemption restrictions that could increase client cost of ownership or limit flexibility.

Under the CFR regime, KYC elements are (a) not limited to personal financial circumstances and (b) consideration of both the client's risk capacity as well as their risk tolerance is required. At a minimum, a KYC update is required every 3 years. The fund salesperson must be able to rationalize why a client of modest means and possibly, with ongoing credit card or other debt, should (a) invest in equity markets and (b) such investments should be invested in a DSC mutual fund. Theoretical and empirical research is available that concludes that the DSC fund leads to an above average conflict-of-interest, requiring above average registrant conflict mitigation measures.

CFR requirements include requirements to inform clients about potentially significant restrictions, costs and limitations relating to the products and service offered to them. There is a requirement now, as well, to provide a general description of the products or services a Firm will offer to clients, and to make it clear that the description must include reference to any restrictions on the client's ability to liquidate or resell a security. There are also new provisions concerning misleading client communications. An ethical salesperson must be prepared to forthrightly articulate (and document) the rationale as to why a DSC fund's inherent restrictions and costs are in the client's best interests.

Salespersons also have to consider liquidity. If the client had little savings and/or no emergency fund, the salesperson would, in principle, have to avoid use of the DSC fund since it wouldn't be in the client's best interest to be locked into a fund for 6-7 years, exposed to early redemption penalties when better alternatives are readily available on the market .At a minimum, some liquid reserves should be available outside the DSC umbrella. In fact, CFR suggests that Firms conduct periodic due diligence on securities on the Firm's shelf which provide third-party compensation to determine whether such securities are competitive with comparable alternatives available in the market (including those that do not provide

third-party compensation) as a control tool when considering how to address material and inherent conflicts-of-interest in the best interest of their clients.

And of course, there is the question of time horizon. Sales to seniors/retirees need to be justified knowing full well that their time horizon is shorter and less predictable than younger people. Putting the client first must surely mean avoiding unnecessary liquidity risk, suggesting that a DSC fund would not generally be seen to be a “best interests” choice for seniors/ retirees or those with serious health problems.

The use of leveraging with DSC funds places clients in an unconscionable high risk situation. Under CFR rules and enhanced internal controls by Firms this scenario is highly unlikely to pass supervisory and compliance scrutiny. To act in the client’s best interests includes justifying not only that (a) the client has the appetite for risk but also (b) the capacity to absorb losses and (c) the need to utilize leverage. A responsible CFR suitability analysis is highly unlikely to justify such a risky portfolio construction and investing strategy.

Even if the DSC sales approach passed all these suitability screens, registrants should be compelled to consider DSC funds with shorter hold periods (Low load funds). It is hard to imagine a scenario where, for retail investors, having a 6 year redemption schedule is better than a 3 year one.

All in all, the number and height of hurdles to recommending a DSC fund have been substantially increased with the introduction of CFR rules. In addition, the added supervisory and administrative burden of selling DSC funds should cause some Firms to change their business models. Improved registrant conduct should lead to a decline in DSC sales and holdings if the CFR principles are followed, regulatory guidance respected and applicable rules are diligently enforced by regulators. That would most certainly be in the best interests of Canadians saving for retirement.

APPENDIX 2 A Message to the Ontario Government

The DSC purchase option may have been created with good intentions, but while the industry and commission structures have evolved, the DSC has not.

Industry participants assert that the DSC sold mutual fund keeps clients invested during market downturns. There is little empirical evidence the DSC fund can help maintain investment discipline, but there is overwhelming evidence it remains open to abuse – whether by selling it to retirees, clients with shorter-term goals, or financially vulnerable clients. The DSC early redemption penalty can keep investors locked into an expensive, underperforming fund for the duration of the redemption schedule.

DSC funds create a compensation conflict when assets at the end of the DSC schedule are replaced with new DSC funds starting the redemption schedule all over again or by expensive front-end load funds that pay a higher trailing commission. If approved, the OSC proposals would, in principle, mitigate this risk.

The Deferred Service Charge fund (oops, deferred sales charge) fund represents a major source of potential harm to small investors. We recommend the MOF read a Report * issued by the OSC IAP questioning whether the advice he believes is being provided is actually being provided to DSC fund unitholders. The survey results raise significant questions about whether most small and mass-market investors actually have access to advice that is comprehensive and timely enough to effectively meet their needs, even though they pay for it.

There is also a rational reason to believe that the lower trailing commission rate of a DSC mutual fund reduces the incentive for salespersons to provide advisory services after the initial sale has been made. MFDA Client research (https://mfda.ca/wp-content/uploads/2017_MFDA_ClientResearchReport.pdf) has found that salespersons with a book size of less than $2 million are most reliant on DSC commissions to finance their operations with 53% of their book in DSC funds. As salesperson book size increases, the amount of DSC within the book declines as less time is needed to be a hunter-gatherer dependent on upfront sales commissions and presumably more time is available to actually advise clients.

The MFDA research also concluded that while it did not collect data on salesperson revenue from insurance activity outside the MFDA Member, representatives with a book of business of less than $2 million are unlikely to support themselves solely from their advising activity and may have other occupations i.e. they are part time workers just starting out, not dedicated investment professionals.

We urge the MOF to apply conditions similar to those proposed by the OSC, on Segregated Funds, an "insurance" product regulated by the FSRA, an entity reporting directly to the MOF. This will help to greatly reduce regulatory arbitrage by dual-licensed mutual fund salespersons.

The government decision not to ban the DSC mutual Fund has had an adverse impact far beyond the harm it will impose on investors. It has impaired the public's perception of the OSC as an independent regulator, disillusioned dedicated OSC staff and led to the resignation of one of Canada's greatest thought leaders on retail investor protection.

The government should relent and let facts and evidence dominate their decision on DSC sold mutual funds.

Kenmar stand ready to meet and discuss the investor protection issues surrounding the sale of DSC mutual funds.

*A Measure of Advice: How much of it do investors with small and medium portfolios receive? *A Measure of Advice: How much of it do investors with small and medium-sized portfolios receive?*

It's time to ban the DSC sold mutual fund.