SIPA

SMALL INVESTOR PROTECTION ASSOCIATION

A Voice for Small Investors
Seeking Truth and Justice

June 1, 2020

Sent via email

The Secretary
Ontario Securities Commission
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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
https://www.osc.gov.on.ca//en/NewsEvents_nr_20200220_osc-proposes-rule-to-restrict-use-of-deferred-sales-charge-option.htm

The opportunity to comment on this consultation is appreciated. The Small Investor Protection Association (SIPA) was incorporated as a national non-profit organization at the end of January, 1999. SIPA is a voice for small investors and advocates for the interests of investors by making submissions and presentations to governments and regulators. SIPA is a non-profit organization and not a registered charity.

SIPA supports a ban on all embedded commissions. We also advocate for a fiduciary standard for the provision of personalized financial advice. SIPA agrees with the CSA Bulletin of Feb. 20, 2020 "With ample evidence of investor harm, especially for the most financially vulnerable investors, and no evidence of any benefits, we see no reason to preserve the DSC option". Nevertheless, comment on the OSC proposals is offered.

Background

This consultation Paper exists only because of political interference with the Ontario Securities Commission's rulemaking process. All other jurisdictions in Canada have already decided to ban the deferred sales charge mutual fund. According to Investor Economics, at the end of 2019, DSC assets in Canada represented 7.4% of the industry total of approximately $1.5 trillion. Their use has been in decline as investors learn of its harmful aspects and CRM2 provides increased cost visibility.

It is our understanding that the reason for this consultation is that the government of Ontario is concerned that the elimination of the DSC option would lead to a reduction or elimination of access to investment advice for those with modest amounts to invest. If this is the case, we can understand the proposed restrictions. For example, the prohibition on the use of a leveraging strategy, which adds significant investment risks, would be unsuitable for clients with modest savings. Although normal suitability criteria should prevent the use of leveraging to such clients, history shows that a definite rule is required to thwart DSC salespersons. Indeed, leveraging could be used by unscrupulous DSC sellers to compensate for the loss of revenue as a result of the proposed amendments.

SIPA does not accept the core argument that a ban on DSC would lead to an advice gap. Banks and many credit unions provide *advice* for account sizes as low as a few thousand dollars. This is also true for digital advisors.

Existing suitability criteria should be adequate to prevent DSC mis-selling whether the amount invested is $50K, $60K or higher. In effect, the OSC has chosen to define a client of modest income as one with $50K or less to invest. Therefore, it seems that the OSC explicitly expects clients with higher amounts to invest to be sold less onerous products as the commissions earned would be sufficiently high to attract dealer interest. In other words only non-DSC products are suitable for more affluent clients while DSC products can be suitable for clients of modest means (and potentially of less financial literacy).

In 2015, York University professor Douglas Cummings, published a report commissioned by the CSA on how fee structures affect fund sales. He found that funds with trailer commissions are far more likely to experience positive inflows; the higher the trailer commissions, the more probable it is to be sold, regardless of past performance. As well, when performance falls, people are much less likely to withdraw money from funds with DSCs and trailer commissions or change dealers.

These findings have a number of implications. The top-performing funds may not be attracting the capital inflows they could be because clients facing a redemption penalty are less willing to sell an underperformer. Poor-returning funds are therefore insulated from redemption and as a result investors may be getting subpar returns. With a DSC. fund, the high upfront commission creates less incentive to generate performance.

Economic downturns such as COVID-19 present a strong case study that illustrates how flexibility and transparency in the investment industry is critical to retail investor security and protection. DSC’s limit investor flexibility; these proposals reduce, but do not eliminate, illiquidity.

Observations and Discussion

A number of restrictions have been placed on the sale of the DSC sold fund. These include, but are not limited to, a constraint based on age, a constraint based on the use of leveraging and a constraint based on account size.

The restriction based on account size is unclear - Does it apply to all accounts (RRSP, TFSA, margin) in total or does it apply to each account? It is assumed it applies to the aggregate dollar amount invested at the dealer. The effect of this restriction will be to limit sale to those with modest amounts to invest. Ironically, it is often those clients with the lowest amount of money who can’t afford to have fees impacting their returns. They also may require access to the funds at unexpected times and will be unduly penalized for early redemption. Simple, low cost investing is most appropriate for such investors. **We recommend that the OSC assess whether such an arrangement is really consistent**

with the objective of providing modest income clients and families a fair chance to meet life financial goals.

It is not clear from the consultation text whether penalties for early redemption apply to the original amount invested in dollars or in units. We have sometimes seen the early redemption penalty applied to the current dollar value being redeemed. **We recommend that disclosure documents be crystal clear as to the formula for calculating the penalty. The same thing applies to the penalty fee free amounts allowed each year and cumulatively**.

The proposals do not set a cap on the upfront commission or the trailer commission rates. **It is recommended that a cap be set.**

In theory, a dealer could counter these proposals by simply offering a front-end loaded fund with a flexible sales commission. The proposed Amendments merely restrict the compensation that members of the organization of publicly-offered mutual funds may pay to participating dealers, and that participating dealers may solicit and accept in connection with the distribution of mutual fund securities.

The consultation proposals are silent on switch fees. These can be material, running as high as 2% of the value of fund assets switched. The OSC may wish to consider providing guidance, as these fees could be a source of investor abuse.

It is recommended that the term "trailing commission" should be defined in regulation so that is clear that the purpose of the trailing commission is to provide personalized advice to clients.

The proposals require that the time horizon be greater than the redemption schedule, which per the proposals is a maximum of three years. For most accounts such as a margin account, TFSA or RESP, this condition would be generally met. In the case of a RRSP/RRIF, the determination of suitability would be dependent on the time horizon defined on the client KYC. **We recommend that the OSC clearly define the term "time horizon "and require that definition be used by all registered dealers on their new account application forms**. It should be noted that there could be multiple time horizons for a client with multiple accounts each with different objectives. Refer to blog on this topic at http://www.canadianfundwatch.com/2020/03/investment-time-horizon-simple-concept.html

The proposals eliminate payment of the DSC early redemption penalty due to critical illness, permanent disability and loss of full-time employment. People could lose their primary income source from causes other than related to employment. Events including the involuntary unemployment of a spouse, divorce or illness of a child or other dependent can have equally devastating impacts on family finances that equally warrant hardship consideration. **It is recommend that the OSC consider other legitimate client hardship situations that warrant penalty-free redemptions from the fund (hardship is not limited to negative shocks that happen directly to the client).**

These are issues that present themselves during times of economic downturn where a lack of flexibility can mean the difference between easily accessing the cash needed to cover living expenses, or waiting and seeking alternative funds through various expensive alternatives such as PayDay loans, or additional borrowings with added interest payments. Small investors should not be put in that position.

Use of a separate series for DSC funds

If the DSC sold mutual fund is to continue to be made available to Ontarians then there should be a separate series with a cost structure that allows it to stand on its own. There should be no cross-subsidization from other funds or series. This could have a very positive effect by disclosing the true cost of the fund. Any upfront payments will have to be amortized over the three year period over the number of units in the DSC series. This should increase the fund MER, making it more challenging for the salesperson to recommend DSC. A separate Fund Facts document would be required.

DSC sales should only be sold by a credentialed "advisor"

In the spring of 2019 the Government of Ontario passed the Financial Professionals Title Protection Act. It will restrict the titles of "Financial Advisor" and "Financial Planner" to persons who hold recognized credentials in good standing from government recognized credentialing bodies. In short, it will ensure that these titles will be backed up by professional standards of education, ethics and proficiency. Ontarians will be able to trust that those who qualify for their use are true professionals. The Financial Services Regulatory Authority of Ontario (FSRA) is operationalizing the regime, with an expected 2021 launch. It is noted however, if only "advisors" are permitted to sell DSC funds, we cannot see how a professional advisor could recommend a DSC fund especially when the sale will have to be under additional constraints imposed by the client-focussed reforms. **If the OSC does not agree with this constraint, it is recommend that the title used should be confined to "Salesperson" so clients know exactly who they are dealing with.**

DSC and the Client-Focussed Reforms (CFR)

The client-focussed reforms which are due for implementation by December 31, 2021 require tighter controls on conflicts-of-interest, enhanced disclosure, cost is to be a factor in suitability determinations and the core requirement that recommendations made should be in the best interest of the client. In addition, under CFR, risk capacity as well as risk tolerance must be considered as part of a suitability determination. Therefore, it seems extremely unlikely that a DSC mutual fund could meet all these criteria and still comply with Best Interests suitability standards. **It is recommended that if the DSC sold fund is to remain an option in Ontario, that the sale of this product should be exempted from CFR requirements.**

Addressable market size not congruent with aim of Ontario Government.

A detailed analysis of the market size by seasoned fund industry executive Eric Adelson concluded *"It appears, therefore, that the DSC market will be limited to a small number of* *investors with very small average account sizes and this will make it difficult for dealers and financial advisors to offer the DSC option. It seems likely that only one or two dealer firms will find that competing in this area is worth the effort. On the fund company side, it will not be feasible to offer the DSC series everywhere the DSC option is currently available, so there will likely be a marked reduction in the availability of DSC mutual funds."*

We therefore conclude that the $50K investment per client restriction imposed on the sale of DSC funds will inevitably lead to their ultimate demise, a result in opposition to the very purpose of the proposals to retain small investor access to the DSC sold mutual fund.
Reference: http://www.eadelson.com/wp-content/uploads/2020/04/OSC-Proposed-DSC-Rule-Potential-DSC-Market.pdf

Effective date is far too lengthy

The effective date of the proposed Rule is June 1, 2022, a transition period of more than two years. (27 months from date of consultation). For well over a decade, the fund industry has known that changes were coming. Nevertheless the OSC is proposing a lengthy period for the industry to change from full DSC to three year DSC, a period during which 6-7 year DSC funds can continue to be sold. These funds will have a tail that could go out as far as 2028! This places small investors in harms way at a time of reduced expected market returns, increased volatility and financial distress. SIPA does not agree with this proposal at all. **SIPA recommends a period of not more than 3-6 months as a transition time.**

Summary and Conclusion

Comments are provided as requested. From our perspective, these proposals will be insufficient to keep small investors from harm.

In summary, SIPA fully supports the CSA ban on DSC mutual funds and does not support the OSC's attempt to allow DSC funds to continues to be sold to small investors.

This letter is approved for public web posting.

Sincerely,

Stan I. Buell

President