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BY EMAIL

June 27, 2020

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8
comments@osc.gov.on.ca

Dear:

Re: ***Ontario Securities Commission ("OSC") Notice and Request for Comment*** **(the "OSC Notice") –** ***Proposed Ontario Securities Commission Rule 81-502*** **Restrictions on the Use of the Deferred Sales Charge Option for Mutual Funds (the "Proposed Rule")** ***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***

I am writing in respect of the OSC Notice of the Proposed Rule relating to the deferred sales charge option for mutual funds in Ontario. Thank you for the opportunity to comment on this important Proposed Rule.

I have been employed as legal counsel for investment management firms for over 17 years, including 11 as General Counsel. I am currently in private practice serving the investment management industry. I have frequently commented on proposed regulation and have participated on OSC advisory bodies. As such, I am very familiar with the instruments and policies for which changes are proposed and believe I can offer helpful insight.

On the same day that the OSC released the OSC Notice, the Canadian Securities Administrators, other than the OSC (the "CSA") , issued *Multilateral CSA Notice of Amendments to Nation Instrument 81-105* Mutual Fund Sales Practices*, Changes to Companion Policy 81-105CP* Mutual Fund Sales Practices *and Changes to Companion Policy 81-101CP to National Instrument 81-101* Mutual Fund Prospectus Disclosure *relating to Prohibition of Deferred Sales Charges for Investment Funds* (the "CSA Notice"). The CSA Notice stands in stark contrast to the OSC Notice in that the former proposed an outright ban on the deferred sales charge ("DSC") option for the purchase of mutual funds whereas the latter seeks to preserve the DSC option with severe limitations. The effect of the Proposed Rule is less clear than the effect of the proposals contained in the CSA Notice.

The OSC deliberately chose to follow a different path from the CSA because of intervention by the Government of Ontario on September 13, 2018. The Government did not agree with banning the DSC option and instead wanted it to be preserved, but with an acceptable level of regulation. The merits of the Proposed Rule, therefore, should be evaluated on that basis.

DSC Generally

The much-maligned DSC played an important role in getting Canadians to invest for retirement. Prior to DSC, any client wishing to invest in a mutual fund would have had to pay a commission to their dealer that could have been as high as 9% (subsequently reduced to 5%). For an investor with $1000, therefore, after buying the mutual fund, their investment would already have declined from $1000 to $910, requiring a 9.9% return after management fees just to break even. As the economy moved away from defined benefit to defined contribution pension plans, this represented an important hurdle to investing at a time when government policy was telling Canadians to invest on their own for their retirement.

Enter the DSC. That same investor now would have the full $1000 invested thus avoiding the immediate $90 loss. The dealer still needed to be compensated for its service and if the full amount was invested, how would a commission be paid? The answer was the fund manager paid the dealer the commission on behalf of the investor. The fund manager viewed the commission as a loan to the investor repaid by (a) the additional investment, i.e. the amount of the commission formerly paid by the investor to the dealer which would now be invested and generating management fee revenue, and (b) management fees over the term of the investment, which was 7 years. Using modest fund return assumptions, the fund manager calculated that with 7 years of management fees, the loan would be repaid and, insofar as the loan is concerned, it would have received an acceptable return. If the investor redeemed before the 7 years, however, the fund manager's calculations would no longer hold and they would be out of pocket. The DSC was designed to offset that loss.

At the time of the initial DSC, the dealer was largely indifferent to DSC or front-end sales because they would get compensated the same. The fund manager still preferred front-end sales since it incurred costs with respect to the DSC that did not apply to sales under the front-end option.

This basic concept does not necessarily hold true today. For example, the highest commission an investor can pay is usually limited to 5%, but over 90% of investors pay no commission and the dealer, instead, receives compensation solely through the trailer commission. Dealers that still charge commissions tend to charge at rates below 5%, perhaps in the range of 3% or less. To compensate for the loss of commission revenue dealers adopted or increased minimum account sizes. The effect of this is that more affluent investors pay proportionately lower costs to investing but less affluent investors increasingly have a harder time getting advice and/or have a narrower range of investment options available to them through their dealer. Dealers that continue to deal with these smaller clients often find it economical to do so because of the commission they receive from the sale of a mutual fund under the DSC option. Otherwise, there would not be sufficient revenue to cover their costs and to compensate for general and specific business risk. Thus, the reduction of front-end commissions to nearly zero has caused the spoken rationale for the DSC option to shift to one of servicing lower-end clients. This is the basis for the Dealer Restrictions part of the Proposed Rule.

The Proposed Rule

The combined effect of the Proposed Rule and the CSA Notice is to reduce an asset market of approximately $170 billion (approximately $76 billion in Ontario, the remainder attributable to the rest of Canada) to approximately $5 billion. [1] How will this affect investors, dealers and investment fund managers?

The effect of the Proposed Rule on investors is nuanced. On the one hand, investors will have shorter DSC schedules, lower redemption fees, and a "free exit" in situations of financial hardship. On the other hand, fewer investors will benefit from these improvements as only investors with $50,000 or less will be able to take advantage of the DSC option. Further, as discussed below, these clients will have a significantly narrower set of investment choices (both in terms of investment fund managers, number of products, and types of mandates) and fewer representatives, or financial advisors, from which to choose. Investors with accounts above that threshold but below account minimums of many dealers of $100,000, will face limitations in seeking advice as well. The alternative for many of these investors will be online "robo" advisors. While this may be an acceptable alternative, it is important to note that these advisors typically offer a much narrower range of choice than is offered by most dealers. (This is typically true of anyone who deals with the public as an "adviser" rather than as a "dealer" as advisers tend to offer proprietary products or set portfolios. For the sake of completeness, however, it is acknowleged that these products or portfolios often incorporate third-party products as components.)

The effect of the Proposed Rule on dealers is negative as it necessarily reduces dealer revenue at a time that they are challenged to generate revenue. For mutual funds that currently offer a 3-year DSC schedule, the longest permitted under the Proposed Rule, the manager pays a commission of 2.5%. The highest commission under DSC currently is 5%. As such, the dealer is losing half of its revenue from clients who continue to be eligible to purchase under the DSC option and 100% of revenue from all other DSC clients.

The effect of the Proposed Rule on investment fund managers is neutral. As the demand for mutual fund securities purchased under the DSC option declines, it is likely that the supply of product under the DSC option will decline, i.e. not every mutual fund that offers a DSC option will continue to do so.[2] Many larger mutual fund companies are planning to offer the DSC option on only a small set of funds. The reason for this is twofold: (1) with a significantly smaller market of investors, the economic rationale for offering the amount of product available today no longer holds; and (2) the cost of offering the DSC option will increase as a result of the requirement in the Proposed Rule to offer it as a separate series.

It is hard to imagine that the foregoing is what the Minister of Finance had in mind when he made his announcement on September 13, 2018. As such, the Proposed Rule falls short. In the remainder of this letter, I will examine each of the IFM Restrictions and Dealer Restrictions in the Proposed Rule.

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[1] Please refer to my note "OSC Proposed Rule on DSC: Potential Market" for an explanation of the figures used in this section. The note can be found at http://www.eadelson.com/wp-content/uploads/2020/04/OSC-Proposed-DSC-Rule-Potential-DSC-Market.pdf and is attached hereto as Appendix 1.

[2] Most recently, NEI announced that it will discontinue offering all forms of DSC, https://www.advisor.ca/news/industry-news/nei-will-discontinue-dscs-this-year, joining BMO and Investor's Group who had previously made similar announcements.

<u>IFM Restrictions</u>

(i) Maximum term of DSC redemption fee schedule limited to 3 years

Shortening the DSC schedule will have the effect of lowering the up-front commission paid by the investment fund manager to the dealer and will make it easier for an investor to exit a poorly performing investment.

Many investment fund managers currently offer a DSC option with a 3-year DSC schedule. It is reasonable to assume that such will become the standard under the Proposed Rule. The relevant features of the current offerings are: (1) the investment fund manager pays to the dealer a commission of 2.5%; (2) the redemption charges in the first 3 years of the DSC schedule are lower than the redemption charges under a standard 7-year DSC schedule.

From an investor's perspective, there is no doubt that a 3-year schedule is preferable to a 7-year schedule as it offers greater flexibility and lower redemption fees should the investor decide to redeem early. From an investment fund manager's perspective, the lower commission paid under a 3-year schedule is beneficial as it reduces the amount of commissions it has to finance, thus lowering its corporate expenses.

From a dealer's perspective, however, the commission is clearly lower under a 3-year DSC option than under a 7-year DSC option and, as discussed above, this could make it more challenging for dealers to take on some DSC clients and will severely impact a dealer's revenue. Furthermore, the lower commission paid on a sale under the DSC option will also reduce the number of dealers and representatives who could or would deal with investors with lower asset levels.

(ii) Clients can redeem 10% of the value of their investment without redemption fees annually, on a cumulative basis

This proposal is reasonable. To the best of my knowledge, every investment fund manager that offers the DSC option allows an investor to redeem 10% of the value of their investment subject to DSC annually without redemption fees. Some offer this as a cumulative entitlement, as proposed, but many others do not. Many of those other companies offer the opportunity annually to switch 10% of their units subject to DSC to the front-end load option, thus eliminating potential DSC on those units. Why this latter practice would be allowed but the 10% entitlement is not cumulative seems inconsistent and it is surprising that market practice has not evolved to a cumulative entitlement. The entitlement should be cumulative.

(iii) Separate DSC Series

The proposal to require the DSC option to be offered as a separate series from the front end load is stated to prevent cross-subsidization, which could theoretically lead to a lower management fee for purchasers of the front-end option is ill-conceived. The concept of cross-subsidization is inherent to pooled investing. The Proposed Rule encourages investment fund managers to charge distribution costs to the fund, contrary to law. The requirement for a separate series introduces unnecessary cost into the system. I will address each of these concepts.

Cross-subsidization is inherent to pooled investing. Typically, cross-subsidization is thought of in terms of operating expenses, not management fees. In that sense, fund operating expenses may include expenses that benefit some investors in the fund but not others. For example, registered plan costs and expenses are typically included in fund operating expenses but only actually benefit registered plan investors. The underlying theory is there are many of these types of expenses which benefit investors but if investors were to be charged separately for each expense from which they benefit, or if a separate series was required in each case, it would become overly complex and potentially uneconomic to offer these services and benefits. The benefits of pooled investing are thought to outweigh these costs.

In contrast, the costs and expenses associated with the DSC are properly characterized as distribution expenses and are not permitted by law to be charged to the fund. These should be viewed similarly to other expenses involved in marketing the fund to the public. All such expenses are paid by the investment fund manager. Similar to any corporate expense, the fund manager pays the expenses out of its cash, which is derived from its revenue. If any of its expenses decrease, its profits will increase. One would not necessarily expect in those circumstances for the management fee to be reduced, although that is an option that a manager may pursue. Similarly, if an investment fund manager reduced marketing expenses, one would not expect a commensurate management fee reduction. For the OSC to even make this suggestion is inappropriate, as it encourages a fund manager to indirectly charge the fund for distribution expenses.

Lastly, a separate series of securities introduces an additional layer of fund operating costs. The additional series would incur audit fees, accounting expenses, and filing fees, among others, that it would not otherwise incur. One might think the combined audit fee of the two series (the new DSC and the old front-end) would simply be the same as the audit fee for the series that already existed but experience is such that that is not the case. Rather, the fee for the original series is likely to be the same and the fee for the additional series is likely the same as well, thus doubling the fee. A similar impact arises from accounting and other fees and expenses that arise in managing a mutual fund. These costs may be significant and will serve to further limit the amount of mutual funds that will offer a DSC series under the Proposed Rule. This requirement has no justification and should be removed.

Dealer Restrictions

(i) No sales of the DSC option to clients aged 60 and over

The effect of restricting sales of the DSC option to clients aged 60 and over is unclear as is the rationale for the restriction. Retirement age is typically 65-67 and, presumably, the concept here is that it is contrary to the public interest for an investor to be subject to DSC in retirement. Therefore, this restriction would make sense if the DSC schedule were 7 years. However, under the Proposed Rule, the DSC schedule cannot exceed 3 years, implying the schedule would end when an investor is 63 years old, still working. In light of the shortened schedule, this restriction should be revised to 62 to 65 years old.

(ii) Maximum client account size of $50,000

The opponents of DSC argue that it is smaller investors who use DSC and these are the most vulnerable investors. In light of that argument, it is unclear why larger investors would need the protection that limiting account sizes to $50,000 brings. This seems illogical.

More importantly, by including this limitation, the DSC market will be significantly smaller than previously and, as a result, the number of DSC offerings will be reduced significantly[3].

[3] Please refer to my note “OSC Proposed DSC Rule - $50,000 Account Size Limit”. The note can be found http://www.eadelson.com/wp-content/uploads/2020/04/OSC-Proposed-DSC-Rule-Account-Size-Restriction.pdf and is attached hereto as Appendix 2.

Many fund companies are already planning to continue DSC on only a very small subset of funds. This will limit the choices for these investors.

The drafting of this particular restriction is especially clumsy, although that may provide a partial solution. The restriction is that the dealer cannot accept a commission from a fund manager if "the dealer knows the balance in the client's account immediately after the distribution would be in excess of $50,000". A client might have a registered and a non-registered account and this drafting implies that the client can, in aggregate, invest up to $100,000 in mutual funds purchased using the DSC option. There is also no reason that a client could not continuously open $50,000 accounts (assuming they have the means) to keep investing in mutual funds bought under the DSC option. I suspect this is not what the drafters of this provision intended but that is the effect of the provision.

(iii) No sales of the DSC option to clients whose investment time horizon is shorter than the DSC schedule

Limiting sales of the DSC option to ensure the schedule does not exceed the investment time horizon is an excellent idea.

(iv) Client cannot use borrowed money to purchase mutual funds with the DSC option

Restricting DSC investors from borrowing money to invest is an excellent idea as well.

(v) Upfront commissions only for new contributions to a client's account

If DSC is conceptually acceptable, as the fact that the OSC is proposing a rule seeking to preserve DSC implies, then it is not clear that clear rules around churning cannot accomplish this same objective. By proposing the Proposed Rule, the OSC effectively acknowledges that DSC is necessary for smaller investors, yet this restriction could unduly limit an investor who initially invested a small amount, holds the investment for a meaningful period of time (so that there is clearly not churning), and then seeks to invest in a "better" mutual fund. If it wasn't economic for the dealer to deal with the client on a non-DSC basis initially and the client only invested $20,000, even if that investment has grown if it is still below $50,000, then the theory of the Proposed Rule suggests that it is still not economic for the dealer to deal with this client on a non-DSC basis. The Proposed Rule prevents that from occurring.

It is not inconceivable that a client with $20,000 would only be able to invest in a mutual fund if the purchase was made under the DSC option. Similarly, for purchases of $30,000, $40,000 or $50,000. If the client achieved a 50% return over the three years and then redeemed for what could objectively be labelled a good reason, the client, under the Proposed Rule, would have difficulty investing that $30,000 since it could not do so using a DSC option. It's only option would be to pay a commission of up to $1,500 on that transaction, an amount that seems rather high for someone to pay at that asset level.

It may well be that this is an acceptable outcome in order to prevent churning of accounts to generate DSC commissions. This is a decision that, if made, should be done consciously and transparently.

(vi) No upfront commissions on reinvested distributions

I'm not aware of any fund manager that pays commissions on reinvested distributions. This would seem like a nefarious practice and should clearly be banned as there is no economic rationale for why the dealer or representative should be compensated for this activity.

(vii) No redemption fees applicable to investor redemptions up (a) death of client; (b) involuntary loss of full-time employment, (c) permanent disability, and (d) critical illness

Every fund manager provides an avenue for a hardship exemption from DSC, although whether to accept the hardship application is discretionary. While technically the mandatory waiver of redemption fees in the prescribed situations is a dealer restriction, the practical reality is that the dealer will seek to ensure that the fund manager pays for this waiver before that company's DSC option will be put on the shelf. This requirement, therefore, removes that discretion and represents a fundamental misunderstanding of DSC.

The commission in a DSC sale is effectively a loan from the fund manager to the client to pay the commission. The loan is effectively repaid by blended payments represented by the management fee charged to the account. To this point, this is not conceptually different from a bank loan. A bank loan is for a set term and if payment is made prior to maturity, a prepayment penalty is assessed because the bank would not otherwise have received the return on the loan that it had bargained for. Similarly, the DSC itself is a prepayment penalty.

Looked at in the foregoing fashion, a societal question is thus raised as to whether the lender should bear the burden of non-payment for reasons that have nothing to do with it. In a bank loan, none of the situations listed in this restriction would result in the loan being forgiven; therefore, it is unclear why the DSC should be waived, and the fund manager should absorb the financial burden. It is one thing for a fund manager to decide that in a particular situation it would like to make a gesture for its client but it is a radically different matter to force that decision and impact the economic rights of the fund manager or the dealer. This is clearly a matter of public policy beyond the authority of a securities regulator and it should not be included in the final version of the Proposed Rule.

Certain restrictions in the Proposed Rule will have impacts that are contrary to the stated purpose of the Proposed Rule, including: the shortened DSC schedule (due to its impact on dealer compensation); the requirement for a separate DSC series (due to the additional costs it will impose on a fund manager, thus making many offerings uneconomic); the 60-year old age limit; the minimum account size of $50,000; and the hardship exemption. Removing or altering all of these restrictions will result in a larger and likely more viable and vibrant DSC market than the one that would result under the Proposed Rule. Absent these changes, the medium-term effect of the Proposed Rule is likely no different than the changes proposed in the CSA Notice.

I would be pleased to discuss my comments further with you.

Sincerely,

ADELSON LAW

Eric Adelson
Principal

APPENDIX 1

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OSC Proposed DSC Rule - Potential Market
Eric Adelson *March 19, 2020*

On February 20, 2020, the Ontario Securities Commission published *Proposed Ontario Securities Commisssion Rule 81-502 Restrictions on the Use of the Deferred Sales Charge Option for Mutual Funds* (the “Proposed Rule”). On the same date, the Canadian Securities Administrators published proposed amendments to NI 81-105 to ban the deferred sales charge option outright. The OSC claims that it wants to preserve the DSC option in some form. In this and a series of articles over the next couple of months, I’ll explore various implications of the Proposed Rule. Today, I want to get a sense of what will the DSC market look like after implementation of the Proposed Rule in its current form.

Among other things, the Proposed Rule limits the DSC schedule to 3 years. There are several fund managers who currently offer a 3-year schedule and they pay the dealer an upfront commission of 2.5% and an annual trailer commission of 0.5%. Therefore, it is reasonable to assume that the standard upfront commission on DSC going forward will be 2.5% plus a trailer commission of 0.5% per year for 3 years, before rising to 1%.

Under the Proposed Rule a client cannot have an account balance greater than $50,000 to be eligible to purchase DSC fund units. Pursuant to the Regulatory Impact Analysis, investors who meet this criterion have average account sizes of $13,000. (Note that as a result of the market impact of COVID-19, this number will likely change due to stock market losses and investors who were in the “over $50,000” category prior to COVID-19 might have accounts less than $50,000 and thus the DSC market under the Proposed Rule might be, at least temporarily, larger – in terms of number of clients - than I have set out here.) A 2.5% commission on $13,000 of transactions is $325 with an annual trailer of $65. Assuming the dealer compensation grid is 50% (and I acknowledge that for some dealers it is significantly more), the advisor himself or herself will only receive $162.50 upon making the investments and $32.50 from that account each year in trailer commissions for 3 years. So, the 3-year revenue for the advisor is $260 or roughly $90 per year. (Yes, there are a few assumptions built into that.) The first point to be made is how much work does one expect a financial advisor to do for $90 per year? It seems clear that the approach to the client will be cookie cutter or formulaic. (Another way to look at this might be what amount of revenue per client is required for it to make economic sense to participate in this business? That question is beyond the scope of this article, but it remains a vital question that should be addressed in this debate.)

If you have a lot of clients and you generated revenue of $90 per year per client, you might have a good business if you had a sufficient number of clients. At 1,000 clients, you would generate revenue of $90,000; at 2,000 clients, $180,000, and so on and so forth. Assuming 250 working days in a year, 2,000 clients would imply meeting or speaking to 8 clients every day, and that assumes you are only meeting or speaking with a client once per year. For a practice with 2,000 clients, there is a fair amount of time spent on business development, so is it realistic to have 2,000 clients? I'd say probably not but for the kind of approach these clients will need, 1,000 seems low, so I would estimate a financial advisor who did this kind of business could handle 1,500 clients and, therefore, would generate revenue of $135,000. Assuming the financial advisor does not also pay expenses out of that revenue and is supported in that regard by the dealer, this seems like a pretty good living and advisors will want to join this business. But is 1,500 clients realistic? My understanding is that a large book of business for an individual advisor is probably closer to 500 clients and this yields $45,000 in revenue for the advisor under the Proposed Rule. It seems unlikely that many advisors would be interested in such a business.

I estimate that the addressable market will be slightly more than 430,000 investors. Data from the OSC and CSA is mixed between households and investors so, based on census numbers, I estimate that a household has, on average, 1.5 investors. (Ontario has 5.2 million householders per the last census; 37.1% of households own mutual funds per the CSA's Consultation Paper 81-408 and 39.4% of those households have less than $100,000 to invest. In the Notice accompanying the Proposed Rule, we are told that 45% of investors have less than $100,000 to invest and this is split 17% with less than $50,000 and 28% with between $50,000 and $100,000.) At 1,500 investors per advisor, this leaves room for about 290 advisors, or 0.8% of the number of advisors in Ontario currently (90,000 advisors in Canada, 40% of the population in Ontario).

The other side of this is whether the fund managers will continue to offer DSC, given that it can only be offered in Ontario and only to clients with account sizes at the dealer of less than $50,000. Using the numbers above, a $13,000 average account size for 430,000 investors translates to $5.6 billion in assets. Compared to the $76 billion today (as estimated in the Proposed Rule), that is 7.3% of the current market! Obviously, in that circumstance DSC cannot be offered on every fund or by every fund manager. $5.6 billion in assets translates to net management fee revenue of $56 million at a 1% net management fee. (1% is accurate historically; however, that figure has been in steady decline for several years, so the net management fee revenue is likely lower than I have estimated.) Spread among 145 fund managers (per IFIC), that is average revenue of $386,200, so obviously few fund managers will offer this series. Offering DSC requires a commitment of the manager's capital to fund the upfront commissions. Therefore, fund managers must consider the return they would get on that capital by offering DSC. Given the limited size of the market, it just will not be economically feasible for the vast majority of fund managers to offer the DSC option. Since DSC must be housed in a separate series under the Proposed Rule, the overhead attributable to DSC will also rise due to series costs and the profitability of DSC will diminish further. While one might assume the big fund managers will stay in this game, that might not be a fair assumption since two of them – IG Wealth Management and BMO – have stopped offering DSC already.

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. Those fund managers that continue to offer the DSC will offer them on only a limited number of funds, and presumably larger, more vanilla-type funds at that. There is no guarantee that the major players in DSC will even continue to offer that option under these circumstances. This should be expected to lead DSC investors to ask what their options are and some of these investors will migrate away from mutual funds. This begs the question, then, whether the Proposed Rule really represents survival of the DSC over time?

APPENDIX 2

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OSC Proposed DSC Rule - $50,000 Account Size Limit
Eric Adelson *April 15, 2020*

Under Proposed Rule 81-502[4], the Ontario Securities Commission (OSC) seeks to severely limit the use of the deferred sales charge option (DSC) for mutual funds rather than banning the practice outright, as the remaining members of the Canadian Securities Administrators seek to do. The OSC seeks to do this by two methods: restrictions on the design of the DSC option, of which there are three, and restrictions on dealer activities in relation to the DSC option, of which there are seven. This article examines one such dealer restriction, the $50,000 account size limit, also referred to as the “Account Size Restriction”.

The Proposed Rule states as follows:

> “Despite section 3.1 of National Instrument 81-105 *Mutual fund Sales Practices*, … (b) a dealer must not accept a commission from a member of the organization of a mutual fund a commission of money for the distribution of securities of a mutual fund made through the dealer, if any of the following apply:…(ii) the dealer knows the balance in the client’s account immediately after the distribution would be in excess of $50,000.”

Assuming the intent of the provision is to limit the use of the DSC to investors who have less than $50,000 to invest, there are two obvious problems with this provision. First, the drafting is clumsy, at best, and I will address this in a comment letter. Second, the restriction seems to be limited to a per account basis. There does not really appear to be anything to prevent a client from opening multiple accounts in order to exceed the $50,000 limit. While these are legitimate issues, more troubling is a disconnect between the regulatory objectives of the Proposed Rule and the Account Size Restriction.

It is important to recount the key issues that arise with the DSC, from a regulatory perspective: [5]

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[4] *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* (2020), 43 OSCB 1575 (the “Proposed Rule”).
[5] *Ibid.* at 1586.

- Conflict of interest misalignment: the misalignment of interests of investment fund managers and dealers and representatives with those of investors
- Cost and service misalignment: the misalignment of embedded commissions with the services provided to investors.

The OSC expects the restrictions in the Proposed Rule to address four enumerated issues:[6]

1. The DSC option is unsuitable for a subset of investors. In a footnote, the OSC asserts that these are investors with time horizons shorter than the DSC schedule and investors who are over 60 years old.
2. Mutual fund purchases that are financed with loans and sold with the DSC option.
3. It is costly for investors to redeem funds before the fee redemption schedule expires.
4. Funds may be unnecessarily churned to generate additional upfront dealer commissions.

A comparison of the Account Size Restriction with the four enumerated issues betrays no obvious connection. As such, the rationale for this restriction must lie in the conflict of interest or misalignment of cost and service.

Typically, in securities regulation the greater the level of assets the less the need for regulatory protection. The rationale for this approach is that the more an investor has at stake, the more likely they are to engage in meaningful due diligence and oversight of their investments, including fee paying arrangements. We see examples of this regulatory approach in the private placement rules[7] and in the registration rules[8]. With mutual funds and investment accounts, there is ample evidence of a correlation between bargaining power and account size. The Proposed Rule turns that on its head and imposes restrictions on wealthier investors that do not apply to less wealthy investors. There is no evidence that the conflict of interest inherent in the payment of embedded commissions increases with value.[9] Perhaps the concern is that the investment fund manager will pay a commission that is too high in relation to the service provided? The OSC has set that out as a distinct issue, so it should be considered apart from the conflict question. It is difficult to conclude that the $50,000 limit is justified on a conflict basis.

The answer must lie in the regulatory concern over the misalignment of the embedded commission and the service. The restrictions in the Proposed Rule serve to limit the market dramatically, as I have previously discussed.[10] One effect of these restrictions is

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[6] *Ibid.*

[7] See, for example, National Instrument 45-106 *Prospectus Exemptions* and, specifically, the definitions and exemptions relating to "accredited investor".

[8] See, for example, National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* and, specifically, the definition and provisions relating to "permitted client".

[9] While dealer would receive a larger dollar amount of commissions in respect of wealthier clients, this does not serve as a great incentive on advisors to recommend DSC securities to wealthier individuals as we see declining use of the DSC at higher asset levels. See Proposed Rule, *supra* note 1 at 1588.

[10] Please see my paper *OSC Proposed DSC Rule: Potential Market* at http://www.eadelson.com/wp-content/uploads/2020/04/OSC-Proposed-DSC-Rule-Potential-DSC-Market.pdf

likely to limit the upfront commission to 2.5%, which translates to $1,250 on a $50,000 account. While the OSC is careful not to mandate a commission level, it is hard to imagine that a three year DSC schedule would pay a materially higher commission given that there is less time to amortize the payment compared with a 7-year schedule (which typically pays a commission of around 5%). We see this already with lower load deferred sales charge schedules where the upfront commission is generally lower the shorter the redemption charge schedule. It is hard to imagine paying an upfront commission higher than 2.5% making economic sense for a manufacturer while also paying a trailer commission. Therefore, the OSC's position arrives at a value for the dealer's and advisor's services of up to $1,250.

Interestingly, the OSC is not concerned about value for service if the client pays the commission directly and it is unclear why that should make a difference. The only difference is who pays the commission. If the compensation were not commensurate with the value of the service, who made the payment would have no relevance to the value question. The implication of the OSC's approach is that it is satisfactory for a client to pay a dealer $2,500 directly for a service – otherwise the lack of value for service would presumably trigger a regulatory response – but it is not satisfactory for the mutual fund company, on behalf of the client (who accepts restrictions for this), to do the same. The closest the OSC comes to an explanation for the Account Size Restriction is the declining use of the DSC as account sizes grow.[11] By the data cited by the OSC, however, it is clear that while usage may decline with wealth it still remains a significant method of dealer and advisor compensation at higher levels of wealth.

It is unclear how the other nine restrictions and limitations contained in the Proposed Rule would not address issues that impact investors with more than $50,000 to invest such that it is necessary to limit account sizes to that level. As such, the Account Size Restriction is ill-considered and does nothing to advance the regulatory purpose of the Proposed Rule. It also serves to reduce the size of the DSC market to an unsustainable level. This limitation should be rescinded as it does not align with the issues that the Proposed Rule seeks to address, its removal would not alter the regulatory purpose of the Proposed Rule, and its inclusion would cause greater harm than its exclusion.

[11] Proposed Rule, *supra* note 1 at 1588.