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July 1, 2020

The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8

Delivered via email to comments@osc.gov.on.ca

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

Thank you for the opportunity to participate in this consultation. For background, I am a principal with HighView Financial Group, a brand name used by HighView Asset Management Ltd. ("HighView" or "HAML"). HAML is registered in the category of Portfolio Manager in Ontario, Alberta, British Columbia, Manitoba, and Saskatchewan. HighView is an investment counselling firm built around the concept of an outsourced chief investment officer (OCIO) for wealthy families and institutions. Accordingly, we are held to a legal fiduciary standard – which we openly embrace and promote – and have created true transparency in our client communications and reporting.

The above-referenced consultation does not affect our firm, but we felt it important to participate in this and previous related consultations to raise standards for the broader industry and to better protect individual investors. I have personally spent the vast majority of my 26-year career on various forms of investor advocacy, including formal responses to regulatory consultations.

The remainder of this submission consists of general comments on the proposals; responses to each of the proposed measures; and some concluding remarks.

General Comments

I fully supported the Canadian Securities Administrators' 2018 proposal to eliminate of all forms of deferred sales charge (DSC) commission for mutual funds – and extending that ban to other product structures. I articulated this in my December 2018 submission[1] and in my follow-up article for Investment Executive's March 2019 issue; aptly titled *DSCs should be banned*[2]. But Ontario's Minister of Finance had other plans; quickly rejecting the CSA's proposals before the consultation started. I still firmly believe that a ban is the best solution. Since that is not possible, the measures proposed in this consultation are, I believe, are the next best solution.

While the sale of DSC mutual funds has fallen significantly over the past twenty years, their use remains significant. Representatives that rely most on DSC commissions tend to administer smaller asset bases; which are made up of more modest portfolio sizes[3]. On the surface, this supports the main argument against banning DSC – i.e. that a ban will make advice unavailable for the average Canadian with modest portfolios. But this argument crumbles under scrutiny; and in the face of empirical evidence.

The chart on the next page[4] shows a clear link between use of DSC commissions and the size of a portfolio. But it also confirms the industry's significant use of DSC commissions for six-figure portfolios. For example, as of 2017, 17% of portfolios valued at more than $500k – and 25% of those valued at $250k to $500k – were invested in DSC funds. That is hardly the small investor about which the industry seems so concerned. Rather, this demonstrates what many have long known – that DSC funds are often used for larger accounts due to lucrative commissions[5]. And those six-figure portfolios are likely to use up relatively more time; leaving little attention for investors with smaller portfolio sizes. The fact that small investors are sold DSC funds is not proof that DSCs buy them access to professional advice.

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[1] My submission to the CSA's proposed amendments to National Instrument 81-105 Mutual Fund Sales Practices (NI 81-105) can be found at https://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20181211_81-105_highview.pdf

[2] See https://www.investmentexecutive.com/newspaper_/focus-on-products/dscs-should-be-banned/

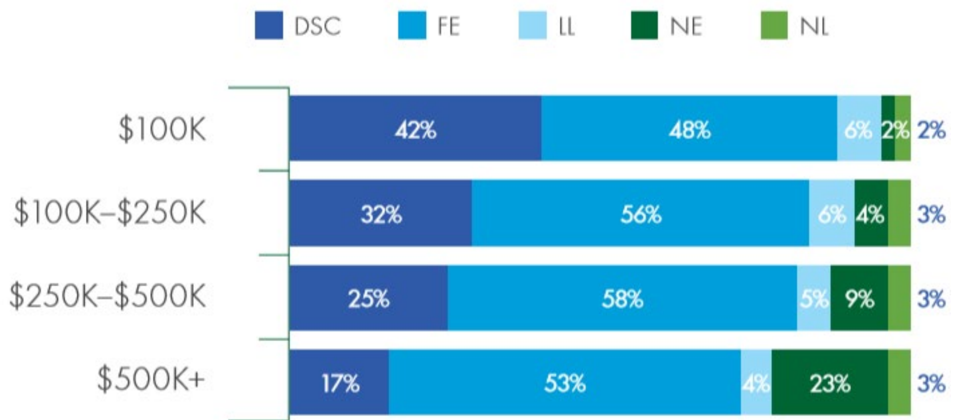
[3] Source: Page 14 of the MFDA Client Research Report published in 2017 based on data obtained during the second half of 2016 http://mfda.ca/wp-content/uploads/2017_MFDA_ClientResearchReport.pdf

[4] Source: Page 15 of the MFDA Client Research Report published in 2017 http://mfda.ca/wp-content/uploads/2017_MFDA_ClientResearchReport.pdf

[5] $250k invested in a DSC fund generates $10,000 to $12,500 of gross commission. A $500k investment generates $20,000 to $25,000 up front. The ranges are based on up from commission rates of 4% to 5% of amounts invested.

Before claiming that investors will lose access to advice, the industry should prove that it provides professional advice to these small investors. The available evidence does not support the industry's claim.

(D.6) Load Type Share by Household Asset Level – Financial Advisory Firms*



* INCLUDES ONLY FIRMS WITH OPEN PRODUCT SHELVES.

I spent many years as a client-facing representative and providing research support to many others in a client-facing role. Most dealer representatives' client books are skewed. It is not unusual for a representative's top 5 or so clients to account for 30% or more of the rep's total client assets. Those same clients will consume a disproportionate amount of the representative's time; leaving smaller clients with very little – if any – service and advice.

While it varies to some degree[6], small investors generally do not get the attention they want or need. This has been my experience; and is supported by Investment Executive's Advisor Report Card annual surveys[7]. The OSC's Investor Advisory Panel added to this evidence when it published the first research report measuring access to advice for investors with smaller portfolios – *A Measure of Advice: How much of it do investors with small and medium-sized portfolio receive?*[8].

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[6] Some representatives and their teams successfully segment clients in a way that gives everyone at least basic service.

[7] See https://www.investmentexecutive.com/newspaper_/focus-on-products/advice-gap-exists-now/

[8] See https://www.osc.gov.on.ca/documents/en/Investors/iap_20190729_survey-findings-on-how-much-advice-investors-receive.pdf

Published in July 2019, the report does not support the industry's often-repeated claim of impending doom for small investors. Among its many findings, 41% of investors with less than $100k in investments had no contact with their "advisor" in the previous twelve months. Moreover, roughly half of respondents with portfolios of up to $250k heard from their "advisor" just once or twice in the past year. It is not a perfect survey, but it is the most concrete research on this subject – and it supports the notion that an advice gap has existed for a very long time. Banning DSC commissions will not worsen access to advice because small investors have had very limited access for many years.

Another industry argument in favour of retaining DSC commissions – courtesy of the Investment Funds Institute of Canada – is unreasonably extreme to prove a point that fails any level of scrutiny. For example, in its December 2018 submission[9], IFIC stated:

> *IFIC believes there is a role for the DSC option for certain investors and certain types of investment strategies. Investors with small amounts to invest on a regular basis who want personalized investment advice continue to be well served by the DSC option. It enables investors to put all of their money to work right away. Paying a fee on a monthly contribution of $25.00, for example, is simply not economical for these smaller investors. It would be an unusual regulatory outcome to make it more costly for smaller investors to invest on a regular basis.*

Let us assume a hypothetical client invests $25 per month in a DSC fund that generates a constant 6% annualized total return (i.e. 0.50% monthly). Let us further assume that a DSC commission of 3% is paid on each deposit with a 1% trailing commission.

- Each $25 contribution generates an up-front commission of $0.75 monthly. Trailing commissions – assuming they are paid monthly – surpass the up-front DSC commission by month 34; and hit the $1 mark in the 43rd month.
- After 10 years, our hypothetical investor would have accumulated approximately $4,100.
- Total commissions, based on the above assumptions, total just over $276 over a full decade; $90 of which would be from up-front DSC commissions.
- Using a 5% DSC commission rate does not lead to materially different conclusions.

[9] See page 2 of https://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20181212_81-105_ific.pdf

Unfortunately, no representative I know is hungry to win this type of client. Even if a rep wanted to service this kind of client, it is the annual trailing commission – not the up-front DSC commission – that accounts for most of the long-term compensation[10]. At the end of a decade of accumulation, annual commissions are insufficient for IFIC's hypothetical small client to attract any meaningful attention. Even making assumptions of large contribution increases still leaves our kind representative with an amount of compensation in year ten that – at best – only supports a basic level of service[11].

This scenario adds merit to my anecdotal experience – that small investors do not have true access to professional advice. Accordingly, the analysis in my *2016 Investment Executive column*[12] remains valid – i.e. an advice gap existed four years ago; exists now; and has long existed. This is not surprising given that the DSC commission structure was never created for any reason related to making advice more widely accessible. Rather it was created to preserve higher up-front commission payments for mutual fund sellers because front-end commissions were declining to zero.

In short, small investors do not have broad access to financial advice[13]. The industry claims that DSC commissions facilitate access to advice for small investors. But my first-hand account of seeing how investors are treated; client-advisor ratios; the time demands of wealthier clients; and the limited but powerful empirical evidence point to small investors' long-standing lack of access to financial advice. The emergence of online digital investment platforms (i.e. robo advisors) and advice-only financial planners have increased access to advice. There is no observable relationship between access to advice for small investors and the existence of DSC commissions.

Moreover, most representatives hold licenses to sell investment and insurance products; giving them a significant secondary revenue source. Generous insurance commissions can provide more than ample compensation for representatives wanting to offer advice and service to clients who are younger or who otherwise have small investment portfolios.

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[10] This is not the case, however, with 'full DSC' – i.e. 4% to 5% up front commissions and 0.25% to 0.50% annual trailers – particularly where contributions are ongoing. In this case, up front commissions dominate.

[11] Even a scenario that has the hypothetical investor double monthly contributions every year until she reaches $1,000 monthly reaches a point – after a full decade – where total commissions just surpass $1,000 yearly.

[12] See https://www.investmentexecutive.com/newspaper_/focus-on-products/dscs-should-be-banned/

[13] One exception is in the case of a small investor with close ties to a wealthy investor or household. The latter can often leverage its advisory relationship to help smaller investors gain access to professional advice.

Specific Proposals

Investment Fund Manager Restrictions

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

- I agree with this proposal. If the DSC commission and redemption schedule are to remain, reverting to a 3-year schedule is a fair compromise.

Section 3(a)(ii) | Clients can redeem 10% of the value of their investment without redemption fees annually, on a cumulative basis

- I agree with this proposal. While at least one comment received to date seemed confused by the use of "units" in one part of the consultation paper and "value" in another; the result is the same[14]. While we agree with this same commenter on the importance of accurate tracking and calculation of redemption charges and 'free units'; this pro-industry commenter appears to be overcomplicating this issue.

    - Investment Fund Managers have long had systems to properly track and make the already-tedious calculations required for DSC fund units. Since each DSC purchase triggers a distinct commission payment and has its own unique redemption schedule and anniversary date; there is no apparent reason why current systems cannot be easily adapted to conform to slightly different rules.

    - New systems are not required. The basic framework is the same – e.g., 3 years instead of 7 years; 3% up front instead of 4%-5%; free unit calculation is the same but cumulative (already in place at several investment fund management firms).

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[14] Suppose an investor purchased 1,000 units at $10 each on a DSC basis. Two years later, the unit price is $11; at which time the investor would like to redeem the maximum amount without attracting a redemption charge. Basing the 'free amount' on original cost – assuming this proposal is adopted – would result in a redemption fee-free amount of $2,000 (i.e. $10,000 original cost x 10% annual 'free' amount x 2 years). If based on market value, the 'free amount' would be $2,200 (i.e. current price of $11/unit x 1,000 units x 10% x 2 years). If based on units, the 'free amount' would be 200 units (i.e. 1,000 x 10% x 2 years); the sale of which would yield proceeds of $2,200 (200 units x $11) – the same dollar amount as the 'market value' calculation.

- That the 10% free entitlement has long been a *use-it-or-lose-it* feature is nonsensical. I have seen many instances of representatives systematically processing 10% 'free unit' redemptions without incurring redemption fees – with proceeds switched into the front-end load version of the same fund. This kind of intra-fund series switching gives rise to a conflict of interest.
    - While this helped free investors from their DSC 'hand-cuffs' it also boosted representative trailing commissions. Making this a cumulative feature will better align with investor interests because withdrawals will occur when cash is needed.

Section 3(a)(iii) | Separate DSC series

- I agree with this proposal. I note that this structure was in place in the early 1990s. At that time, most mutual funds with embedded compensation had three or four series of units – A, B, C, and sometimes D – each with its own commission or load structure. Accordingly, each series also had a unique management expense ratio (MER) reflecting the cost of each. The industry did away with this practice – claiming investor confusion – by consolidating all series of units into the more expensive DSC series of units[15].

Dealer Restrictions

Section 3(b)(i) | No sales of the DSC option to clients aged 60 and over

- I agree with this proposal.

Section 3(b)(ii) | Maximum client account size of $50k

- I agree with this proposal; but only if new DSC purchases result in a maximum up front commission payment of 3%; implying a maximum commission of $1,500 up front (max $50k of purchases x 3%).
- Dealers will also need to monitor this on a household basis so that multiple accounts are not opened for $50k or slightly below to get around this restriction to maximize commissions.

[15] There was merit to the investor confusion argument. In those (pre-internet) days, clients looked up mutual fund prices in the print newspaper and were often confused by which series they held. However, rather than taking this investor confusion as a challenge to make product labels clearer, the industry chose to default to expensive simplicity.

- While not formally part of these proposals, I suggest a 3% maximum commission rate – which will limit the potential for abuse. There is sufficient historical precedent of investment fund managers juicing up-front or ongoing commissions to attract more sales. While I believe that such tactics are less likely to work today; there is still potential for abuse. A maximum commission rate will impede the commission-gaming tactics that have occurred in the past[16].

Section 3(b)(iii) | No sales of the DSC option to clients whose investment time horizon is shorter than the DSC schedule

- I agree with this proposal. I note, however, that this was more meaningful under the traditional 6-7 years redemption schedule. Still, with many money market and short-term bond funds offering a DSC commission option, this proposal is necessary to minimize the potential abuse of these proposed changes.

Section 3(b)(iv)(A) | Client cannot use borrowed money to purchase mutual funds with the DSC option

- I agree with this proposal. While I agree with the policy rationale – i.e. avoiding redemption fees if leveraged investments must be sold to pay investment loan – there is a significant conflict of interest associated with advising an individual to borrow money and investing loan proceeds. This conflict is magnified when DSC commissions are involved.

- During my 26-year career, I have witnessed – on many occasions – representatives advising their clients to borrow hundreds of thousands of dollars to invest those proceeds in DSC investment products in a lump sum. For example, $500,000 invested in a DSC product currently generates $20k to $25k in up front commissions. Even with a reduced 3% commission rate, that's $15k in up front commissions. It is fraught with conflicts. In my opinion, this is the most important measure proposed in the OSC's consultation paper.

[16] For reference, many companies in the past have offered above-market trailing commission rates – either as a firm or on specific products. Moreover, some fund companies – admittedly a minority – have in the past offered up front DSC commissions to dealers of 8% to 10% of the amount of purchases.

Section 3(b)(iv)(B) | Upfront commissions only for new contributions to a client's account

- I agree with this proposal. Specific rules and guidelines will need to be written in a way that minimizes the potential for abuse so that the results will be consistent with the spirit of this proposed measure. Dealers will need processes to monitor compliance with this restriction; like those needed to monitor compliance with the $50k maximum account size for DSC investments.

Section 3(b)(iv)(C) | No upfront commissions on reinvested distributions

- I agree with this proposal. I note, however, that I am not aware of any instance of reinvested distributions currently triggering new commissions.

Section 3(b)(v) | No redemption fees applicable to investor redemptions upon: a) Death of client, b) Involuntary loss of full-time employment, c) Permanent disability, and d) Critical illness.

- I agree with this proposal. I have three comments on this item.
    - Involuntary loss of full-time employment may be difficult to prove; unless a record of employment is required to qualify for redemption fee waivers.
    - Also, this strikes me as more of an investment fund manager requirement – not a dealer requirement. It is the IFM that pays the up-front commission; and it is the IFM that collects the redemption fee to recoup its initial commission outlay. Accordingly, it is the IFM's fee to waive – not the dealer's – in these circumstances.
    - In line with some commenters' recommendations, it is prudent to include vulnerable clients not covered by the aforementioned restrictions (e.g., cognitive impairment).

I share Ken Kivenko's concern that a two-year transition period will allow DSC sales to continue unabated. I support ceasing the sale of DSC products immediately (as many firms have already announced), with a transition of one year (i.e. effective June 2021).

The ideal outcome would have seen Ontario join the rest of the country in banning DSC commissions. Faced with the challenge of an unsupportive government, I applaud the OSC for these proposals which – if implemented – will minimize the potential harm to retail investors until a ban is possible.

Please feel free to reach out should you wish to further discuss this issue or any part of this submission.

Sincerely,

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