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July 6, 2020

VIA EMAIL

Ontario Securities Commission

Attention:

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

Dear Sirs/Mesdames,

Re: OSC Notice and Request for Comment Proposed Rule 81-502 *Restrictions on the Use of the Deferred Sales Charge Option for Mutual Funds,* Proposed Companion Policy 81-502 OSC Rule 81-502 and Related Consequential Amendments

We are writing in respect of the OSC Notice and Request for Comments on Restricting the use of the Deferred Sales Charge Option ("**DSC**") for mutual funds[1] (the "**Notice**") and related proposed amendments and consequential amendments as set out in the Notice (collectively, the "**Proposal**"). Thank you for the opportunity to submit comments.

Invesco Canada Ltd. is a wholly owned subsidiary of Invesco Ltd., a leading independent global investment management company dedicated to helping people worldwide get the most out of life. As of May 31, 2020, Invesco and its operating subsidiaries had assets under management of approximately USD $1.14 trillion. Invesco operates in more than 20 countries in North America, Europe and Asia.

General Comments

Invesco has long advocated for investor choice, having submitted comment letters on Canadian Securities Administrators ("**CSA**") Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees*[2], CSA Consultation Paper 81-408 *Consultation on Banning Embedded*

[1] (2020), 43 OSCB at 1575.
[2] http://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20130412_81-407_adelsone.pdf

Commissions[3] and CSA Notice and Request for Comment 81-105 *Mutual Fund Sales Practices.*[4] We continue to believe in choice today, and while we acknowledge that the rest of the country is moving past DSC, we appreciate the OSC's thoughtful proposals that aim to mitigate the negative outcomes of DSC.

We have argued in the past that the DSC has generally outlived its usefulness, with one potential exception for modest investors who often cannot afford to pay much for advice but still wish to receive professional investment advice and portfolio management. While we would prefer a world where dealers do not need to rely on any sort of upfront commission to provide service to their clients, we recognize that not all business models are there yet. It is for that reason that we are **supportive** of the OSC's proposals, although our letter will suggest certain changes to make the Proposal more practical. We also hope to raise additional questions which we believe are worthy of further regulatory guidance or comment.

As a general comment, we note that a regime that allows DSC options to be purchased in one province but not others creates shared compliance complexities for both dealers and fund managers, and those complexities should be acknowledged. For example, questions may arise when an investor from Ontario holding DSC products moves to another province (where DSC is banned). How would dealers be expected to handle such a situation if a redemption occurs during the redemption schedule period but immediately after the client's move from Ontario? Does the move itself trigger a fee? How should a dealer handle pre-authorized chequing plans (PACs) or rebalancing services in that context, and what is the required timeframe to make any appropriate changes? These complexities may cause confusion or conflicting practices, and so we would urge the OSC to consider them and provide appropriate regulatory guidance in due course.

Finally, we would also like to commend the OSC on a well drafted Proposal, and in particular, we appreciate the helpful regulatory impact analysis. While we do not agree with everything in the Proposal or the impact analysis, it is clear that the OSC thought through the Proposal carefully in light of the regulatory challenges DSC raises. We hope that our comments helpfully contribute to the discourse.

Separate DSC Series

The OSC argues that a separate DSC series will eliminate the cross-subsidization relating to the costs associated with the payment of upfront commissions on DSC and low-load sales, and seemingly bases this on a review of a limited number of funds that offer a separate DSC series for the same fund. In our view, and as we have argued in the past, cross-subsidization is an inherent feature of pooled investing, not a bug. It allows the sharing of costs for the overall benefit of all investors. Clearly, creating new funds or series for each potential item that may push costs from one group to another would lead to far less choice and higher costs for investors, which is not in the public interest.

In that light, it is unclear to us as to why DSC in particular is more offensive than other forms of cross-subsidization, especially where the quantum of subsidy in other forms is significantly higher than DSC. For example, under the current tax regime in Canada, many investment managers (including Invesco) charge a blended rate of HST on management and

[3] http://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20170609_81-408_adelsone.pdf
[4] https://osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20181213_81-105_abrahams.pdf (the "**81-105 Letter**")

advisory fees, due to the varying rates of HST across provinces. Under this model, investors in higher tax jurisdictions are being subsidized by investors in lower tax jurisdictions who are otherwise paying a higher fee. According to one estimate, the value of this subsidization is approximately CAD$800 million per year.[5] The most equitable way of dealing with this cross-subsidization (apart from eliminating the requirement to charge HST on management and advisory fees) would be to require separate series for each province with differing tax rates. However, no one reasonably advocates for that solution to be imposed on all investment fund managers because it would be utterly inefficient and would lead to significantly less choice for investors in some provinces. The same considerations could be applied to nominee and client-name accounts within the same series, as there are significant cost differences between these two account types, given the added processing and administration requirements relating to client name accounts. In our view, the same idea applies to DSC.

We also note that by taking the position that any cross-subsidization should be allowed by DSC, the OSC undermines its argument that its central concerns relating to DSC is the fact that a conflict of interest arises, because cross-subsidization has nothing to do with the conflicts raised by DSC.

We have also argued that a separate series for DSC will not result in the savings expectations outlined by the OSC.[6] We will not rehash these arguments but believe that the OSC will be disappointed that its prediction of lower management fees and higher net returns for investors does not pan out if a separate DSC series is ultimately required.

In our view, a requirement to launch another DSC series will cause fund managers to carefully consider whether it makes economic sense to spin out new series for each of their funds, especially if the opportunity set is limited to only Ontario investors. Adding new series to an investment fund manager's shelf is an expensive undertaking and generally not efficient for investors (and as an aside, we note that the new DSC series will likely have higher MERs in part because the full amount of HST for Ontario will be charged to that series, as opposed to a blended rate, which is disadvantageous for modest investors the OSC is trying to protect). We believe that many fund managers will conclude that it does not make sense to launch separate series, which brings us to the fundamental argument against this proposal – it will have the inadvertent consequence of limiting investor choice relating to which funds (and investment fund managers) they can invest with. In our view, these limitations would not protect DSC investors – they would hurt them, and so this proposal should be reconsidered.

10% Free Redemption

The OSC is considering a requirement that investment fund managers avoid paying a commission to a dealer unless clients are able to redeem at least 10% of the number of securities that would otherwise be subject to a redemption fee for free. We acknowledge that this is common practice in our industry - Invesco provides this service to investors in our funds, as do our competitors. The OSC is also proposing to allow investors to carry forward any unused portion of this entitlement to the next year.

It is unclear to us what the policy rationale is for expanded the 10% free redemption amount to include the ability to carry forward any unused allowances, other than "greater flexibility" as noted by the OSC. If adopted, this requirement effectively amounts to a transfer of

[5] https://business.financialpost.com/opinion/jack-mintz-another-way-the-west-is-getting-a-bad-deal-from-ottawa-paying-hst-on-investment-fees
[6] See page 5 of the 81-105 Letter.

value from one party to another, and the greater flexibility provided to investors may actually come at a cost by reducing choice to investors. It is also important to note that most mutual funds are designed and should be treated as longer-term investments, and the 10% free redemption rule was brought in by the industry to accommodate hardship scenarios while not fundamentally changing the economics of the DSC.

Apart from the proposal to carry forward unused free redemption entitlements to the next year, we are not opposed *in principle* to the codification of the 10% free redemption rule. However, we are unsure as to why this practice requires codification in the first place. Is the OSC concerned that investment fund managers will take away this right following the application of the Proposal? Have there been investor complaints made against firms who do not offer it? We are not aware of widespread investor concern but if that concern exists, we believe that it should be noted.

We also believe that codification may lead to unintended consequences without further regulatory guidance. While this proposal is meant to simply codify industry practice, industry practice varies in small but important ways. As such, we suggest that the OSC acknowledge that the proposed language in paragraph 3(a)(ii) does <u>not</u> remove the flexibility of the investment fund manager to calculate how it applies the 10% free rule in determining which units are subject to the fee (and what the fee is). We suggest that the easiest way to do that would be to confirm that the OSC believes that the term “securities that would otherwise be subject to a fee” is not prescriptive to a particular set of rules, but rather permissive and flexible.

An example of the complexity may be helpful in articulating the issue. At Invesco, the 10% free entitlement against DSC redemption fees is calculated by taking 10% of the number of shares or units held in an account at the end of the prior calendar year (*including* matured units), adding 10% of the number of shares or units purchased or received in the current calendar year within that account, and then reducing the value of those amounts by the value of any applicable cash distributions received in the current year. Further, at Invesco the redemption fee is then calculated on the *cost basis* on remaining shares or units that fall outside the 10% free entitlement. Some firms may not include matured units or cash distributions in their redemption fee calculations. Others yet might calculate the redemption fees based on current market value, rather than on a cost basis. We do not believe there is a single, unified way to calculate the 10% free allowance, and while we read the proposed wording in paragraph 3(a)(ii) to be permissive of differing calculation methodologies (so long as firms apply their respective methodologies consistently and they meet the technical requirements as presented), in our view it would be beneficial for the OSC to confirm this view.

The Age Limitation

Under a regulatory regime where enhanced suitability and KYC requirements are correctly applied (and strictly enforced), an age limitation on DSC should theoretically not be necessary because the particular situation and objectives of a client would determine whether DSC makes sense for that client. Consider an example with two hypothetical investors – one is a 50-year old who was just laid off due to the COVID-19 pandemic and who receives a severance of $50,000, and the other is a 60-year old self-employed individual with no intention or desire to retire anytime soon. In our view, one can persuasively argue that it would be far less suitable for the 50-year old in our example to invest their severance in the DSC option relative to the 60-year old investor, given their respective circumstances. However, the age limitation suggests otherwise, which is an odd result.

We appreciate that a bright line test cannot, by definition, take context into consideration, and therefore will not always be fair for clients in all circumstances. The OSC seems to be saying that, suitability notwithstanding, at age 60, investors should not be in DSC anymore because at that age it is more likely than not that DSC will not be suitable. While we believe that it would be optimal to provide registrants with clear regulatory expectations about when DSC is suitable and when DSC is not suitable, especially in light of the potential conflicts of interest, we understand the OSC's position and are ultimately supportive.

If the OSC is indeed committed to an age test, however, we would submit that it would be optimal to increase the upper limit to an age which more closely aligns with the practice of many Canadians who are working longer and retiring later. We believe that one could persuasively argue that age 68 would be a more appropriate age, given that on a three-year DSC schedule, investors would be at age 71 when the schedule runs out, and that is the age when investors must begin to decumulate registered retirement savings plan (RRSP) assets by way of a registered retirement income fund (RRIF). On the other hand, age 65 tends to be the commonly referred to as 'retirement age', so could easily be considered an appropriate age. The OSC does not provide the rationale for why it chose age 60 as the last year for which investors can purchase DSC, other than to imply that this would protect against mis-selling for 'seniors' and that approximately a third of investors who own mutual funds are 60-years old or older. In our view, a specific rationale for whatever age is ultimately used should be provided if using a bright line test.

Regardless of what age is ultimately chosen (if at all), there are some practical questions that require additional regulatory guidance. For example, in determining whether to apply the age limit on a joint account, should the age test apply to the oldest or the youngest investor within that account? Moreover, should the age limit apply for trust accounts, such as a registered education savings plan account, where the beneficiary is not going to be in the age group where there is a potential DSC concern? In our view, the policy rationale for an age limit would not apply in either case (and certainly not in the RESP context), but clarity should be provided by the OSC to avoid unnecessary client frustration.

Maximum Account Size

While we agree that it is primarily the modest investor that will make use of the DSC option to obtain investment advice, we do not understand the policy rationale behind the proposal to require that *only* modest investors may avail themselves to it. The OSC does not seem to articulate that rationale, and we do not believe that it is self-evident. This maximum account size restriction will, in our view, significantly reduce the ability of dealers and advisors to offer DSC and will therefore limit investor choice.

An example may help articulate why we also do not believe that $50,000 is the right limit to set. At that amount, and assuming an average commission rate of 2.5% on a 3-year DSC schedule, the maximum amount of upfront commission that can be earned by and advisor is $1250. This commission would be supplemented by a small trailing commission as well, paid over time. However, according to the OSC, only 17% of investors have account sizes less than $50,000, and the average values of their accounts is only $13,000. At that account size, the average advisor commission is $325 ($13,000 multiplied by an expected DSC commission rate of 2.5%). The OSC is therefore effectively proposing to reduce the size of the market by 83%, making it uneconomical to realistically provide this option to investors because advisors would be limited to an unsustainable level of compensation (which is also split with the dealer). In our view, if a minimum account size is necessary, it should be significantly increased so the majority of the market can utilize it, rather than 17%.

We also note that the Proposal requires the dealer to know that the balance in the client's account is not in excess of $50,000 before accepting a commission. However, dealers can easily get around this requirement by opening up multiple accounts for the client. While we do not believe this is the OSC's intention, we believe it is an important point to clarify.

Redemption fee exemptions

Invesco believes that a hardship exemption to allow clients to redeem their investments during challenging times without incurring redemption fees is a worthy undertaking. As we have seen during the recent COVID-19 pandemic, financial hardship can hit families at unexpected times, and the industry should take appropriate steps for the benefit of the investing public.

While we laud this proposal, we worry that registrants are not well suited to make determinations as to financial hardship in many cases. Dealers do not have medical experts on staff and will struggle to determine whether a client has in fact experienced a critical illness or permanent disability that meets the requirements set out in the Proposal. Asking dealers to make this judgement call will increase costs and create uncertainty for both them (since a portion of their compensation could be clawed back) and clients (who will understandably be upset when they believe they should not have to pay redemption fees but have not sufficiently convinced their dealer). We urge the OSC to consider how to provide additional guidance to allow for this type of analysis to be conducted in an efficient and fair way.

Responses to Specific Questions

Below we have provided responses to the specific questions raised by the OSC in the Notice:

1. *On January 10, 2017, the Canadian Securities Administrators (the CSA) published for comment CSA Consultation Paper 81-408 Consultation on the Option of Discontinuing Embedded Commissions (the Consultation Paper). The Consultation Paper stated that some investors may indirectly subsidize certain dealer compensation costs that are not attributable to their investment in the fund, which means they indirectly pay excess fees. As an example of this "cross-subsidization", the Consultation Paper made reference to the financing costs incurred by investment fund managers in connection with the payment of the upfront commission to dealers that is typically associated with the DSC sales charge option. This financing cost could be embedded in a mutual fund's management fee, which would result in some investors in a fund, such as the front-end load investors, cross-subsidizing the costs attributable to DSC investors in the fund. As a result, we are proposing to require the DSC sales charge option to be included in a separate series of the fund, which would have its own management fee. We note that some investment fund managers already use this practice. Do you agree that mandating a separate DSC series will help in curtailing the cross-subsidization of the costs attributable to DSC investors? Why or why not?*

   Response: Please see our responses above in the body of our letter. We do not believe that mandating a separate DSC series will meaningfully reduce costs for non-DSC investors.

2. *The effective date of the Proposed Rule coincides with the effective date of the final amendments to implement a DSC ban in the other CSA jurisdictions. Are there additional transition issues that we should consider?*

   Response: We are supportive of aligning the date of the Proposal with the implementation date for the DSC ban in the other CSA jurisdictions. Using another date will cause compliance headaches and would not be efficient.

3. *Annex E sets out the anticipated costs and benefits of the Proposed Rule. Are there any other significant costs or benefits that have not been identified in this analysis? Please explain with concrete examples and provide data to support your views.*

   Response: In our view, taken together, the Proposal will likely reduce the ability of investors to receive advice from independent dealers and advisors. As we have argued before, this primarily helps low cost robo-advisors (which may not be desirable for many investors) or banks. As an independent investment management firm, we believe that limiting choice has a high cost that is sometimes not quantifiable, but is certainly real and not in the interests of the investing public.

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Conclusion

We would be pleased to discuss our responses in greater detail at the OSC's convenience.

Thank you for the opportunity to comment on this important matter.

Yours truly,

Invesco Canada Ltd.

Shalomi Abraham
Senior Vice President, Head of Legal – Canada

cc: Kate Archibald, Senior Vice President & Chief Compliance Officer, Invesco Canada Ltd.
John Zerr, President & CEO, Invesco Canada Ltd.