Via Fax and Email

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Mr. John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
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Toronto, Ontario M5H3S8

Re: Response to the OSC's Fair Dealing Model Concept Paper

Dear Mr. Stevenson:

PFSL Investments Canada Ltd. ("PFSL") sincerely appreciates the opportunity to submit comments in response to the Fair Dealing Model Concept Paper("FDM") proposed by the Ontario Securities Commission ("OSC"). Our company is a subsidiary of Citigroup Inc., the preeminent financial services firm in the world with over $1 trillion in assets and over 100 million customers in 100 countries. PPFSL has been serving small investors in Canada since 1986. PFSL, headquartered in Ontario since 1991, has perhaps the largest mutual fund-licensed sales force in all of Canada, with some 7.5 percent of all Canadian licensed mutual fund representatives.[1] PFSL currently administers approximately 1,000,000 mutual fund accounts, with 55% of its customers in Ontario. What is perhaps most unusual about PFSL is the market we serve: lower-to-middle-income Canadians. This is a segment of the population PFSL understands extremely well.

PFSL supports the core principles of the FDM, including clear allocation of responsibilities, increased transparency, and better management of potential conflicts of interest. However, we have grave concerns with the FDM's proposed fundamental overhaul of the existing market structure in the absence of empirical evidence of pervasive investor protection issues that need to be addressed.

We have worked closely with the Investment Funds Institute of Canada (IFIC) Fair Dealing Model Working Group on their comprehensive submission and we agree with the industry-wide concerns raised in the IFIC submission, as well as the alternative solutions it proposes. Those comments are the culmination of months of thoughtful work and we believe that they are well balanced.

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[1] Prior to the establishment of PFSL, representatives offered investments to their clients through an unaffiliated dealer. The MFDA reports that there are fewer than 60,000 mutual fund licensed salespersons in Canada, 4,494 of whom are engaged exclusively with PFSL.

In this response, PFSL wishes to focus on the FDM's likely impact on *small* individual investors, the very group that mutual funds were designed to serve. After careful reflection, it is clear to us that the proposals could benefit high net worth and active investors, but for the vast majority of Canadians the FDM would likely have severe negative consequences. Despite a well-meaning intent to furnish market participants with personalized, expert advice, we fear that the FDM would disenfranchise a substantial segment of the population who cannot be accommodated within the narrow three-tiered categorization of financial advice.

These foreclosed participants, we know from 23 years of experience[2], will be the very customers we support: lower-to-middle income consumers who simply cannot afford the costly interaction and documentation the FDM would mandate. Far from achieving a utopia of educated, well-counseled investors, the FDM would divide Canadians, even more than today, into two basic groups -- those individuals able to pay the freight of "reform" and those whose limited financial resources exclude them from receiving any meaningful financial advice at all. By structuring a "one-size-fits-all" Advisory category, covering even the most basic advice, the FDM could force the lower income consumer into the "self-managed" category or to exclusion from the market altogether.

There is also a huge, and worrisome, unknown embedded in the FDM: the licensing and proficiency regime. It is critical to a business model geared toward the small investor to have a licensing system that is accessible to new representatives. The OSC contemplates a wholesale reworking of the licensing and proficiency regimes in a second Concept Paper for release at a later date. We fear that a radical change of the existing licensing and proficiency regime could result in a diminished supply of financial services representatives. This again would harm small net worth investors, as the system would shut out representatives willing to assist smaller investors who cannot pay high commissions or fees.

Our specific concerns are set forth below.

I. Disenfranchising Small Investors

PFSL is a registered mutual fund dealer with 4,494 mutual fund registered salespersons across the country, 2,417 of whom are in Ontario. With 981,851 mutual fund accounts, PFSL is responsible for approximately $4.4 billion in assets under administration.

Having operated in Canada since 1991, PFSL serves the lower-to-middle income investor who traditionally has been ignored in the financial services sector. Indeed, over 75% of the accounts maintained at PFSL have a balance under $5,000.

[2] PFSL is an affiliate of PFS Investments, Inc., which has operated in the United States since 1981.

Taking a somewhat "old fashioned" approach to client service, a PFSL representative typically will meet clients in their home across the kitchen table. The representative will discuss simple solutions to basic financial needs – term life insurance for income protection (if dually licensed), and a menu of head office-approved mutual funds to establish retirement, education and savings plans.

Typically, clients in the lower-to-middle income groups do not have large initial funds to invest and often lack the disposable income to accommodate large future investments. Trade sizes, accordingly, are quite small. On a monthly pre-authorized chequing basis, PFSL drafts 196,000 customers' bank accounts an average of $49 each. Given the trade sizes, the payout to a sales representative is quite modest. As would be expected with customers possessing little disposable income, the vast majority of PFSL's clients have a long-term savings objective. To illustrate, eighty-three per cent of our accounts are registered retirement products and four per cent are registered education savings products.

The myriad of new procedures proposed by the FDM would impose on firms suffocating costs that, ultimately, must be borne by retail investors, with a disproportionate impact on small investors, who dominate PFSL's client base.

Dealer costs would increase, we believe, to such an extent that businesses like ours could no longer afford to serve the average Canadian. Ironically, the approach offered by the FDM could have the unintended consequence of hurting the very segment of investors it was intended to help most. Over-regulation would create problems much like the UK market challenges recently addressed by the Financial Services Authority ("FSA"):

> [P]rinciples of good regulation require us to be mindful that we are regulating for all the population requiring protection, and not for a privileged sub-group. There is always the risk of building up over a period of years a "Rolls Royce" regulatory framework, which is an expensive burden on the value chain between providers and consumers. It could have the effect of excluding less well off consumers, because the cost of regulation makes it uneconomic for the industry to service them.[3]

The FDM's overly prescriptive approach would inevitably create a cascade of regulations. Wholly aside from the overwhelming burden of increased costs, this array of regulations would be virtually impossible to administer for a firm, like ours, that services a large number of small accounts. "Death by regulation" is a genuine concern of ours as we contemplate the impact the FDM could have on the small investor. The FDM would exacerbate the existing problem of an increasingly complex web of rules and regulations applicable to Canadian investment firms.

[3] C. P. 121, p. 29, §3.50.

A. Excessive Cost Increases to Dealers and Investors

Nowhere in the FDM paper is there an estimate of the costs of the proposed new regulatory model. Rather, the OSC leaves this issue to a future "cost-benefit analysis." The document only suggests vague cost saving opportunities, such as firms "shar[ing] costs by outsourcing some compliance activities to an intermediary". (FDM at p. 80) A meaningful and practical discourse about the FDM proposals requires identification of the financial impact on the industry and individual firms. Our initial conclusion is that the added costs will be so prohibitive that the model is impractical from the start.

The fact is that almost every change suggested by the OSC is an entirely new expense without any apparent countervailing savings. While the savings are difficult to quantify, the costs are hard and real -- up-front systems development and programming costs, continuing systems maintenance costs, printing and distribution costs, training costs, compliance costs and additional staff and overhead costs for monitoring, to name a few.

The FDM would require firms to design completely new systems to create new disclosure statements, confirmations and other point of sale documents. Similarly, post-sale monitoring systems also would have to be created. The magnitude of the new costs could be huge. In the United States, for example, a far less intrusive regulatory proposal that would require broker-dealers to add certain point of sale disclosures to trade confirmations has been estimated to cost over $1 million per firm in up-front expense and close to $750,000 in ongoing expense. Industry-wide in the U.S., those costs could exceed $5.4 billion to implement and could add ongoing expense of $7 billion.[4] The reality is that investors would end up bearing the added cost in order for dealers to stay in business.

Some dealers would be unable to absorb these costs. There would be a disproportionate impact on small dealers and investors. Canadian regulatory expenses already are too high. A recent Harvard Law School study by Professor Howell E. Jackson found that the cost of securities regulation per dollar of market capitalization is about one and a half times greater in Canada than in the United Kingdom and almost three times higher than in the United States.[5] Higher regulatory costs reduce the return to investors and raise the cost of capital to issuing companies.

As the SEC recently stated, "[a] 1% annual fee, for example, will reduce an ending balance by 18% in an investment held for 20 years."[6] In the context of PFSL's typical clients, the value of an account with a $1,000 initial investment and an 8% annual return

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[4] SEC Rules 15c2-2 and 15c2-3. For expense estimates, see, Comment of the Securities Industry Association dated April 12, 2004 at pp. 11-14.

[5] See Wise Persons' Committee to Review the Structure of Securities Regulation in Canada, Submission of the Canadian Council of Chief Executives, 2003

[6] Final Rule: Shareholder Reports and Quarterly Portfolio Disclosure of Registered Investment Management Companies, Investment Company Act Rel. No. 26,372 (February 27, 2004).

would be reduced over 20 years by more than 25% if costs were increased by only $25. A cost increase of $50 in that same account would reduce its value by more than 50%. Thus, even seemingly minor cost increases could disenfranchise small investors, eliminate smaller dealers from the market, reduce competition in the industry, and drastically affect the service provided to ordinary investors.

While PFSL has not had an opportunity to compute the precise costs associated with the FDM for our firm, the list below reflects some of the new expenses that would be extremely large and would have a devastating effect on our lower-to-middle income consumers.

1. The Fair Dealing Document.

The FDM mandates a Fair Dealing Document to be completed for each client at the account opening stage. This document must be tailored to each client and updated for significant changes in clients' circumstances.

The FDM also contemplates mandatory education for investors, through a medium such as a video. Although a generic presentation could be used, many dealers would need to produce their own presentation to ensure consistency with their business model. This would entail production and delivery costs.

2. Transaction Reporting

The FDM would require increased reporting, before and after each transaction, involving multiple steps and departments.

3. Account Statements

The FDM would require personalized account statements to be provided on a regular basis, with personalized performance information, aggregate costs of compensation and an analysis of the portfolio's risk level.

4. Licensing and Proficiency Requirements

As the FDM does not set out the licensing and proficiency requirements, it is not possible to estimate the potential cost impact. However, changes to the existing process would entail significant costs for systems development, training and administration.

5. Monitoring Requirements

The new monitoring requirements proposed by the FDM would add costs for developing policies, procedures and forms. Systems would be required to track and control the completion and updating of documentation. Additional staff would be required to

monitor the output of these systems, and compliance and audit staff would be required to ensure the systems were operating effectively. More specific monitoring issues and costs would involve the account opening, the transaction, relationship maintenance, representative licensing and proficiency requirements.

B. Inflexible Regulatory Framework

There are only three proposed relationships for advisors and investors, and none of the categories is entirely appropriate for the PFSL business model. The FDM contemplates a single Advisory category in which purchasers of plain vanilla mutual funds are served by the same advisor as investors seeking complex advisory services such as wrap accounts, REITS, limited partnerships and similar products.

PFSL's concern is that the business model of firms serving small investors is incompatible with the highly prescriptive FDM and that an attempt to accommodate multiple relationships would be impractical. Chiefly, the issue is one of time relative to compensation. No distinction is made in the FDM between large, medium and small asset accounts. The list of advisor obligations is the same. Yet, the available compensation can differ markedly. Firms will have no choice but to avoid small accounts that cannot afford to pay the commissions or fees required to perform the extensive analytical and monitoring functions mandated by the FDM. The suggestion in the FDM that compensation should be limited to fee-based arrangements for advisors is even more frightening. Our experience is that small investors will be discouraged from seeking investment advice if they must pay upfront hourly or fixed fee rates.

C. Prohibiting Third-Party Compensation

The FDM's proposal to prohibit third party compensation would be a substantial interference with a long-standing industry practice. We are unaware of hard evidence establishing a problem in this area that needs to be addressed in such drastic terms. Eliminating such compensation would make it even harder to serve smaller investors since the investor would now face an increased *and* upfront cost.

PFSL is particularly concerned with the information and discussion in Appendix F: Compensation Biases, with respect to proprietary funds. Appendix F identifies that it may be more profitable for a dealer to sell its own proprietary funds than mutual funds managed by a third party. The FDM also identifies that incentives based on the amount sold of any particular product would create a conflict of interest and that such conflict has already been addressed by requiring compensation disclosures and through National Instrument 81-105, the Mutual Fund Sales Practices Rule. PFSL agrees that the FDM's objectives may be accomplished through enhanced transparency and the requirement that salespersons not be influenced by compensation in the recommendations made to clients. PFSL submits that the OSC's intent with respect to the regulation of proprietary funds requires

clarification. Will mutual fund dealers continue to be allowed to manage and distribute proprietary funds?

Appendix F, pages 7 & 8, proposes a complete prohibition against third party compensation in the mutual fund industry. A better approach would be to improve transparency with respect to third party compensation. The best interests of investors would be served with plain language disclosures on fees, expenses and commissions at the point of sale and continuous disclosures thereafter such as mandated by proposed National Instrument 81-106. PFSL submits that the best way of addressing investor protection issues with respect to compensation issues is through enhanced transparency and continuing disclosure. There appears to be no compelling reason for disrupting the current competitive marketplace and imposing any untested alternative.

D. Licensing and Proficiency

The degree to which lower and middle income consumers receive financial advice is a function, in part, of the number of financial representatives able and willing to service this segment of the market. Mutual fund sales representatives are not Certified Financial Planners (CFPs) nor could they be – the low commissions available in this market segment could not support the advice function CFPs offer to higher end investors.

The FDM puts forward, partially to justify the elimination of third party compensation, that all mutual fund salespersons would achieve a degree of proficiency and accreditation beyond the current regulatory requirements. PFSL's concern is that the FDM proposes to eliminate the current category of mutual fund sales registrant. A large number of mutual fund dealers could go out of business, and many of the current mutual fund registrants would disappear. As a result, a large segment of the investor market may be deprived of access to investment services. Once again, it is impossible to evaluate these complex proposals without fully understanding the proficiency and licensing standards being contemplated by the OSC and without the benefit of an industry impact study.

Again, the FSA recognized the danger of such an approach in the UK:

> It would not be appropriate to expect product providers and intermediaries falling within the normal span of commercial activity to service and sell investment products to the least well-off consumers (i.e. those on very low incomes, often with no other financial assets, possibly in receipt of benefits, for whom a recommendation to buy a savings product would be unsuitable advice). Rather, we should seek to review the regulatory cost of investment advice to ensure that the costs imposed by regulation are proportionate to the risks faced by consumers, and do not present a barrier to the uptake of appropriate advice by different groups of consumers. We would wish for an outcome that made it commercially viable for firms to serve those lower-income consumers for whom a recommendation to save would be suitable. The

cost of training and employing advisors is one disincentive to provide advice to lower-income consumers, as things stand.[7]

II. Are the Dramatic Changes Necessary?

The OSC acknowledges that the FDM "represents a significant change from the way the relationship between investors and financial services providers is currently regulated." (FDM at p. 7) This being so, it is important that the change be necessary, for any tinkering with a province's market structure is by its nature a risky proposition.

With respect, nowhere does the OSC explain why it is necessary to rewrite the whole approach to investments in Ontario. There is no evidence offered to suggest that the mutual funds industry at large is non-compliant or fails to follow acceptable practices or codes of conduct. Similarly there is no hard evidence that investors are unduly at risk. For example, an analysis of complaints investigated by the Ombudsman for Banking Services and Investments *(Report on activities for the twelve month period ending October 31, 2003)*, reveals that there were only 46 MFDA complaints out of a total of 321 Banking Services and Investments complaints. This is an extremely small number given that Canadians hold more than 50 million mutual fund accounts.

Healthy mutual fund sales indicate a high degree of trust and satisfaction with the industry. No current survey of investor attitudes has been conducted to justify the sweeping proposed changes in the FDM, nor has there been a methodical evaluation of purported problems with the market structure, as one would expect before such revolutionary change is proposed.

III. Harmonization:

A new regulatory regime in Ontario, that in many cases duplicates or overrides existing national rules, will create significant problems and costs for companies, such as ours, that operate nationally. British Columbia is about to introduce legislation that enshrines their vision for securities regulation. There have been a series of new and revised national instruments that mutual fund dealers have been working hard to keep up with. The MFDA and other SROs have also been introducing new rules that apply nationally. All of these admirable investor protection measures have a cost to our industry and hence will have an impact on the cost to investors. PFSL has been diligent in keeping up and complying with all applicable rules, regulations and procedures. We have a very strong internal compliance system and various checks and balances in order to protect investors. But adding a new layer of rules and regulations – ones that only apply in Ontario – is not in the interest of financial service providers or the investors they service.

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[7] C. P. 121, p. 74, § 5.21.

IV. CONCLUSION

PFSL appreciates the opportunity to comment to the OSC, and has great respect for the role of the OSC and for the extensive thought and analysis that has clearly been applied to the FDM proposals.

As indicated in this response, however, PFSL has serious concerns about the practical impact of many of the proposed changes, which would significantly increase costs to dealers and therefore to consumers. For the small investors to whom PFSL caters almost exclusively, the effect of the FDM proposals, if adopted, could be to deprive them entirely of access to investment advice.

PFSL is hopeful that a meaningful dialogue will ensue among the OSC, other Regulators, SROs, the industry at large and PFSL in particular, as all parties search for the most appropriate way to regulate the industry and protect the interests of Canadian investors. For that reason, we urge the OSC to rethink having the Working Groups devote their attention solely to "implementation," which implies that the model has passed the evaluative stage. We believe there are too many unknowns in the proposal to make implementation a next step. Rather, we respectfully ask the OSC to allow the groups to perform additional study of the many outstanding questions. In addition, we think it essential to conduct the cost/benefit analysis now as well as to consider the licensing issues at this time. The FDM is so important a concept that it only can be evaluated as a whole with all of parts laid out in detail.

Again, we appreciate the OSC's consideration of our views, and we look forward to a continuing dialogue, with the ultimate goal of reaching a regulatory balance that provides appropriate protection to consumers while allowing different business models to remain economically viable.

Very truly yours,

(original signed by)

John A. Adams
Executive Vice-President &
Chief Executive Officer
PFSL Investments Canada Ltd.