Joseph L. Rotman School of Management
University of Toronto

Rotman

April 11, 2013

RE: CSA Discussion Paper and Request for Comment 81-407

To All CSA Members

British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Registrar of Securities, Prince Edward Island
Nova Scotia Securities Commission
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

I am an Associate Professor at the Rotman School of Management and work directly on research related to the mutual fund industry. Most recently I published a paper in the *Journal of Finance* in February 2013 which specifically considered the conflicts of interests arising from payments to advisors. Because of the closeness of my research and interest in the topic, I thought I would first reflect on the outcomes and limitations of research in this area and as well provide some comments on the CSA discussion paper.

My research project was based on data from the US which was retrieved from the SECs N-SAR filings. One of the benefits to researchers of having electronically available reporting through EDGAR is it makes it immensely more straight-forward to gather data and do analysis. As an aside, efforts to encourage electronic reporting in Canada would certainly help increase independent research studies that may prove beneficial to regulators. While the study was the first to explore directly the effect of payments on flows, our data relies on aggregate flows to the fund as we did not have access to

105 St. George Street Telephone: (416) 946 5647 E-mail: susan.christoffersen@rotman.utoronto.ca
Toronto, Ontario, Canada M5S 3E6 Facsimile: (416) 971 3048 Web site: www.rotman.utoronto.ca/schristoffersen

individual account data that may be even more informative about the effects of fees on investor decisions. These are the conclusions and observations we reached in our study:

1. The compensation to advisors was largely dependent on the size of the fund, the past performance of the fund, and category of the funds. Larger fund families and funds were able to negotiate lower payments to brokers since the smaller funds were more dependent on the advisors to sell. Also funds with lower performance had to pay more to advisors to sell since these are presumably the more difficult types of funds to sell. This raises the concern that small funds trying to start out and compete in the marketplace need to compensate these brokers more to sell their product. Smaller funds may therefore have an increasingly more difficult time in entering the market, reducing competition.

2. We discuss to some extent a relatively common practice in the US of revenue-sharing where managers can share some of the revenue earned from management fees with advisors who sell the fund. While restrictions on 12b-1 fees are being discussed, there is nothing that precludes a manager from charging a slightly higher management fee and compensating brokers through profit-sharing.

   While we are not certain to what degree this practice is common in Canada, it is certainly something to be cognisant of in designing regulation. Limits placed on trailer fees may simply cause these payments to be paid indirectly through other outlets where there is less oversight. The SEC is now considering whether widespread disclosure of these additional advisory payments should be made public to investors. If regulation moves towards having the advisory fee separately disclosed to investors, the disclosure of advisory fee should try to be all-encompassing and include all sources of where advisory payment can come from even if these payment channels are not observed now.

3. Excess payments made to advisors either through upfront loads or ongoing payments drastically altered the dollar inflows into these funds. More payment strongly associated with larger flows. We saw a very distinct difference between whether these flows were accessed through a related (captive) broker selling mostly their own product or an unaffiliated broker selling a wide range of mutual funds from different fund families. Potential conflicts of interest were more evident when the broker had a larger selection of funds where they could direct investors because paying the advisor a little more in this context would result in a larger redirection of flows. While captive channels are typically associated with conflicts of interest with fund manufacturers selling their

own funds, the potential for payment to influence the allocation of investment is much stronger in the third-party channel.

4. Lastly we considered the outcomes for investors in these funds and considered one-time front load payments compared to ongoing payments. We found that in general investors who paid a large one-time upfront load to the broker had negative excess returns when looking at the year following their investment. This highlights the problem of a one-time payment to an advisor—the compensation is not tied to the return outcome of the investor so the broker is not penalized for placing an investor in a bad performing fund (or high fee fund).

   In contrast, we did not see a similar erosion in performance when the broker was paid with an ongoing fee. The ongoing payment aligns the incentives of the broker with the investor in terms of wanting to place the investor in a fund that subsequently does well since this would improve the ongoing broker payments.

   The finding suggests that the trend away from sales charges to ongoing fees is potentially moving towards a better payment structure for investors. Payments which tie the broker to the future outcome of the investor will be better at helping to improving the outcomes for investors. Still, as the discussion paper outlines, there are very serious issues surrounding a manager's ability to allocate the MER towards the advisor without consultation with the investor. This ability to alter trailing fees paid to a broker can seriously affect where money is allocated (as discussed in point 3 above) which may not be in the best interest of the investor in terms of finding the least costly fund or the fund with the best risk profile for the investor.

Comments on the Discussion Paper:

In my view, one of the most important issues to resolve is the potential conflict of interest arising from trailer fees. Because we know payment to advisors does influence their advice, then the discretion of the manager to allocate the MER to the advisor without consultation with the investor could lead to conflicts of interest. For example, higher advisory payments may be used to entice flows in general or in particular to high expense funds where managers are most likely to benefit. Separately disclosing the amount paid to the advisor will help investors understand how the advisor is paid and could then be used to easily compare across alternatives creating more competition on this dimension of mutual fund pricing.

Although not raised in the discussion paper, fee-based models of distribution could fall into similar problems when different services are bundled into a single price. There is room to alter how the fee is split for different services which can reintroduce biases. While fee-based models are a small part of the Canadian market now and are not well-studied, a single price for multiple services opens up the potential for payments to advisors to be shifted without consultation with the investor. One potential outcome of restrictions placed on trailing fees is that it may encourage funds to move towards a fee-based structure that in turn reintroduces similar problems.

Another consideration is the desirability of having comparable costs across countries. IFIC has gone through enormous efforts to try to provide comparisons of fees between Canada and the US. The fact that MERs in Canada include trailer fees and yet the US reports MERs without trailer fees makes it difficult to compare. The possibility that revenue-sharing arrangements in the US may add to advisor payments and are largely unobserved in either Canada or the US makes it difficult for investors or regulators to observe these payments and compare. The comparison in fees at the end of the discussion paper is immensely helpful and efforts to make this comparison easier for investors and academics would allow us to reach better conclusions about how Canadian mutual fund fees measure up in the world.

Finally, taxation in Canada and the US differs where Canada imposes a tax on management fees that is not levied in the US. From a policy perspective, serious consideration needs to be given to the implications of imposing taxes on management fees. If a country wants to encourage investor savings and in particular investors saving for retirement, taxing investors on their savings seems counterintuitive. In the very least, it would only seem consistent with calls for transparency that the taxes paid to government be itemized as a separate component of management expenses for investors to see.

Thank you for the opportunity to comment on this discussion paper. I believe authors have compiled a very thorough and complete overview of the Canadian markets and commend the Canadian Securities Association for undertaking this task. It highlighted what I believe are the critical issues to resolve. I hope that my comments above will help add onto what is already a comprehensive analysis of an important issue.

Sincerely,

Susan Christoffersen