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April 12, 2013

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
Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Nunavut

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Re: Canadian Securities Administrators (CSA) Discussion Paper and Request for Comment 81-407: *Mutual Fund Fees* (Discussion Paper)

We are writing to provide comments on the CSA's Discussion Paper on mutual fund fees published on December 13, 2012.

Investment Planning Counsel Inc. (IPC) is a diversified financial services company and is a large manager and distributor of mutual funds in Canada, with assets under administration of over $17 billion at March 31, 2013. IPC distributes its products through approximately 780 sales

representatives engaged with its subsidiaries, most of whom are Approved Persons with the Mutual Fund Dealers Association of Canada, who provide financial planning solutions to approximately 214,000 accounts in Canada.

IGM Financial Inc. (which in turn is a member of the Power Financial Corporation group of companies) owns approximately 95% of IPC.

IPC has served the financial needs of its clients for over 15 years. That history, which represents the collective experience of millions of transactions with investors, provides IPC with a deep perspective of the subject matter covered in the Discussion Paper.

Unfortunately, our conclusion is that the view taken in the paper and the options considered are the product of an approach that only considers a narrow perspective of the Canadian mutual fund industry. As a result, the adoption of many of the proposals may have a very negative effect on the various constituencies involved in this industry, particularly individual Canadian investors.

Before making any significant changes to an industry as important and complex as the Canadian investment fund industry – and the options considered in the Discussion Paper would fundamentally reshape it if implemented – It is important to have a broad and deep understanding as to what their affect may be. We strongly believe it is important to provide our views on these issues and to raise certain concerns as to the unintended consequences that may result.

1. Overview

A central focus of the Discussion Paper is on how advisors are paid for the financial products they recommend to clients. The paper identifies a number of potential conflicts of interest that it sees as inherent in the current model and considers changes that it believes may address those conflicts. In our view a key problem with the Discussion Paper is that it does not consider all of the context and history underlying the current distribution environment.

IPC's business model is built on the importance of long-term relationships with clients. Our experience has shown that this is the key to helping individuals reach their financial goals, at each stage of their lives. Simply put, we see financial planning and advice delivered through an advisor as an integral part of working with clients to reach those targets. Advisors keep clients focused on their long-term goals but their advice is not paid for directly by them. Instead, it is generally paid by clients indirectly, through compensation embedded within the fund's expenses. It is on this basis that IPC, like most of the industry, have structured our business practices and the compensation paid to our advisors, all with our clients' long term interests in mind.

Financial advice has significant value to investors, something that has been clearly demonstrated by independent research. This is true at all income and asset levels. In particular, advised households:

- are twice as likely to save for retirement at all ages
- have significantly higher levels of investable assets at all ages
- improve their regular saving for retirement at all income levels

- rate themselves as more financially knowledgeable; and
- are more comfortable making the financial decisions they need to make to plan for their future.

The benefits that accrue to both individual investors and Canada at large are incontrovertible.

However, the current compensation model was not always the dominant one. At an earlier time, mutual funds were generally sold with a front end load. Clients paid an initial fee at the time of the purchase but there were no trailing commissions. However, investors became dissatisfied with this structure, which had the effect of reducing the net amount they had invested. As a result, the prevailing compensation model moved away from one where the advisor compensation was paid separately by the investor to one where these expenses were included in the cost of the product.

Embedded compensation is not limited to mutual funds and in fact is the dominant structure in the Canadian financial services industry. Excluding the mutual fund industry, embedded compensation is the standard in approximately 45% of the average Canadian household's investments in deposits and segregated funds[1].

The embedded compensation model is structured so that the initial cost of the financial planning advice is amortized over the life of the investment, even though much more time and effort is involved by the dealer and the advisor at the time of the initial investment. Because a major portion of the advisor's compensation is paid out over the lifespan of the investment, this model has the significant virtue of aligning the advisor's success with the client's (it will increase as the value of the client's portfolio goes up and decrease if it declines). In addition, this ongoing revenue stream to advisors provides a basis for them to provide ongoing advice to clients, as long as the client remains with the advisor.

Most investors have preferred to pay indirectly for advice and even if they mature to the point of being willing to pay directly for such advice, time is no longer their ally in meeting their financial goals.

Countries, such as the United Kingdom and Australia that have banned embedded compensation are beginning to experience unintended negative consequences, namely an "advice gap". Although the regulators' intentions may have been good, an increasing number of investors there are finding that they are no longer able to access the guidance they need to manage their investments[2] and meet their financial planning needs (either due to their smaller account size or

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[1] These financial products represent approximately 40.7%, 4.0% and 25.5% of Canadians' household balance sheets respectively (see Investor Economics. *Household Balance Sheet 2012.*

[2] Deloitte LLP, *Bridging the Advice Gap: Delivering investment products in a post-RDR world.* November 2012.

their reluctance to pay for such services). In light of the fact that access to financial advice and positive financial outcomes are strongly correlated, this is a very unwelcome turn of events.

In contrast, in Canada most Canadians can obtain financial advice through their mutual fund investments. Historically this has led to very positive results compared to other countries[3]. As the experience of these other countries has shown, wholesale changes to the current compensation model in Canada in the nature of those proposed in the Discussion Paper have the potential to create and hasten an "advice gap" here. This would be a very negative and undesirable outcome.

Unfortunately, the Discussion Paper focuses only and entirely on mutual funds and the presentation of the issues which is, unfortunately, misleading and potentially tarnishes the mutual fund industry as a whole. It leaves the impression – which is unfair and unfounded – that (i) the embedded compensation model is unique to the mutual fund industry, (ii) market forces are not driving out sufficient innovation, (iii) current regulations are lacking and (iv) our clients are exposed to unmanageable conflicts that do not occur elsewhere. No support is provided for these propositions and in fact the overwhelming evidence is to the contrary, namely that the existing structures have served the public very well, and will continue to do so.

2. Comments on Specific Proposals

The following are our comments on each of the series of proposals the Discussion Paper sets out for consideration.

A. Tie Trailing Commissions to Advisors to Specific Services

This proposition is based on a misunderstanding. It assumes that all trailing commissions are paid for ongoing services provided by advisors. This is not the case. Compensation is paid to the dealer in connection with the distribution of the financial products and, in the case of mutual fund dealers, is generally their only source of revenue. This income stream pays for a variety of costs the dealer incurs: supervision, back office functions, client statement production, insurance and similar expenses, among others (many of which, we note, have increased as a result of recent regulatory requirements), in addition to the cost of compensating advisors. Importantly, manufacturer does not determine the level of service advisors are to provide. Instead the dealer does.

On average, approximately two-thirds of the trailing commission received by a dealer is actually paid to its advisors. In turn, these payments have two aspects. They represent deferred compensation to advisors for the initial work done by them in providing advice to clients at the time of the original investment and they compensate advisors for the ongoing service they

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[3] Based on *Canada's retirement-income provision: An international perspective* by Edward Whitehouse Retirees in Canada have well-above average income adequacy compared to other OECD countries (while Australia and the UK are well below average), and Canadian retirees derive a very large proportion of their income from accumulated capital, and little from public transfers when compared to the OECD average.

provide to those clients. As a result, the services provided by advisors to investors will vary depending on a number of factors. These include the size of a particular client's portfolio and their specific needs, including expected frequency of contact and updates.

B. "Do It Yourself" Classes for all Funds

Investors who choose to invest without the assistance of an advisor, the "Do It Yourself"(DIY) option, are already able to buy a wide range of investment products that have no trailing commission, including mutual funds. If additional options are required, the market will respond to those needs, if there is investors demand for it. However, the idea of mandating a DIY class for all mutual funds does not make sense. Fund manufacturers have always been able to structure their offerings for the clients in the market they wish to serve. Some choose to focus only on investors who seek advice. The freedom to make this choice must be respected. Similarly, a manufacturer that opts to provide products to suit a broader range of investors should be able to do so, including offering products suited for clients at discount brokers who do not provide advice. Historically securities regulators have not interfered in the commercial decisions made by market participants and this is not the place to start.

If the concern underlying this aspect of the proposal is the situation where an investor using a discount broker may be paying a trailing commission without receiving the advice associated with it, this is not the way to address this. Instead the issue should be left to the self regulatory organizations (SROs) in Canada that oversee dealers. These SROs are able to deal with any issues that exist in this regard. Further, we understand that this is already a question that is under active consideration and this process is the appropriate manner to review this matter.

C. Unbundling Trailing Commissions in Favour of Asset Based Fees

Past experience has shown that trailing commissions are rarely increased by fund managers. In this context, unbundling the trailing commission component of the MER would not represent an enhancement to the present compensation model. Further, the trailing commission element of mutual fund expenses is already fully disclosed in public documents filed with regulators and provided to investors, unlike other financial products with embedded ongoing compensation. This change in structure is unnecessary and would potentially be detrimental to investors, increasing complexity for the client and adding undo administrative process and costs.

D. Separate Series or Classes for No Load Funds

A number of Canadian fund sponsors already use this approach, while others do not. Fund managers should continue to have the option to choose how to structure their offering. The position in the Discussion Paper that sponsors should have to offer separate classes for no-load and deferred sales charge (DSC) options is based on the incorrect premise that unit holders choosing the no load option are cross-subsidizing those choosing the DSC option. This argument is not supported by actual experience. Although DSCs have an up-front commission paid, they also are typically combined with a lower ongoing trailing commission compared to no load. Which pricing option (if any) proves to be costlier to the fund manager will depend on the specifications

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of the product. Again, the DSC pricing option arose in response to investor demand and has important beneficial features (most notably aligning advisor and client interests) that the Discussion Paper ignores.

Nonetheless, we believe that the proposal that fund manufacturers should have separate series or classes for each purchase option deserves consideration. This recommendation has the advantage of potentially bringing increased clarity to investors as to the various purchase options available to them. At the same time, we also believe that whether or not a fund manufacturer wishes to offer these separate series (and at a separate cost) should be market driven and not mandated by regulators. We are also concerned that the administrative effort and costs of such a requirement would be significant. Since these expenses would be borne by investors we are unconvinced that the benefits would outweigh the costs of implementing this proposal.

E. Setting Maximums for Commissions

In Canada, compensation and commissions have been historically determined by market forces. This should continue. Canadian securities regulators should maintain their reluctance to regulate in this area. This matter is best left to the competitive forces that shape the market. The public has been well served by freedom to competition and this should remain a cornerstone of the financial services sector in Canada. The crucial policy concern should be to ensure that consumers have a wide range of options to choose from, which they have.

Further, there is no trend in the Canadian mutual fund industry towards increased costs or in the payment of higher commissions to advisors. Accordingly, if this is the motivation for capping commissions, there is no evidence to suggest this is necessary. Indeed, the key cause of significant increases in Canadian fund MERs has been the introduction of new taxes (GST in the 1990s and, more recently, HST in Ontario and other provinces). After account for these government imposed costs to the investor, MERs have been in fact been trending steadily down due to market pressures.

Capping commissions also introduces other potential unintended negative consequences, including new and potentially more harmful sources of conflicting interests. In particular, it could encourage churning on the part of advisors to generate additional commissions, or could lead to "regulatory arbitrage". This is the movement to other similar investment vehicles, such as segregated funds, which are very similar in economic terms from mutual funds but which, as insurance products, are regulated under different rules. Further, capping commissions would likely prompt dealers and their advisors to limit their client base due to the ongoing costs associated with maintaining, supervising and reporting on an account which are no longer economic.

F. Adding Additional Standards for Advisors

The question of whether the relationship between advisors owe and their clients should be governed by a new "best interest" standard is extensively discussed in CSA Consultation Paper 33-

403: *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty when Advice is Provided to Retail Clients.*

Advisors are already subject to a duty to act fairly, honestly and in good faith and are governed by a comprehensive set of obligations based on recommending only suitable investments for clients. Unfortunately, that consultation paper does not make the case as to how imposing a "best interest" standard would enhance the present situation or how the current regulations are somehow inadequate. Our concern is that imposing a new standard could only increase uncertainty and restrict the access of investors to affordable advice. For the same reasons as we give in this letter, this would be a very negative development for clients. We would direct you to the comment letter we submitted on that paper for a more detailed discussion.

The Ontario Securities Commission Investor Advisory Panel and the Investor Education Fund recently released the results of an investor survey, which seems to be intended to support the proposal for a statutory best interest duty for advisors[4]. Our review of this survey leads us to conclude that it lacks the qualities to provide useful and unbiased information.

We note that the conclusion in the survey that investors agree that "a best interest duty is needed to protect retail investors" is based on responses to a single question in the survey, which is preceded by a leading statement that "it is not clear whether the 'best interest duty' applies to financial advisors". The concern is the lack of context, that there is no reference to the existing regulations already in place, namely the suitability obligation and duty to act fairly, honestly and in good faith and no indication of the increased cost or reduced access to financial advisors that would likely result if a best interest duty were to be applied. The result is that respondents are given the misleading impression that current regulations are inadequate or do not existent at all, and that the implementation of these new requirements would have no effect on their access to financial advisors.

In addition, the framing of much of the language in the survey is misleading and gives a biased impression of the mutual fund industry. In particular:

- Instead of asking about "embedded compensation", the survey asks about fees that are "hidden"; mutual fund fees are in fact completely disclosed in various public documents that are provided to investors, namely the Fund Facts and Simplified Prospectus.
- The statement is made in the survey that mutual fund fees are "sometimes quite high"; this opinion as to whether fees are high should have been left to the respondent.

[4] "Strengthening Investor Protection in Ontario - Speaking with Ontarians", prepared by Ascentum, Inc. on behalf of the Ontario Securities Commission Investor Advisory Panel and the Investor Education Fund, January 2013.

- The survey states that investors choosing stocks and bonds can "benefit from lots of available information". This leaves the incorrect impression that stocks and bonds have more information available to them than on mutual funds, which is simply incorrect.

We strongly believe that given this deficiencies with this survey, reliance should not be placed on it as to the question of investors' views on the proposed statutory best interest standard.

G. Prevent Manufacturers from Setting Compensation for Advisors

Our view is that the proposal to discontinue the practice of having manufactures set the compensation for advisors is based on an incorrect premise that must be clarified. Compensation for advisors is not set by fund manufacturers. In fact, mutual funds sponsors structure their offerings to provide for the payment of commissions to dealers. In turn, those dealers enter into arrangements with their advisors for the payment of compensation. The specific arrangements a particular dealer puts in place are dependent on several factors, including the costs the dealer incurs in its operations and the competitive environment in which it carries on business. Importantly, the percentage of the compensation received by dealers that is passed on to its advisors has been steadily trending downward. A key cause of this is the increased costs faced by dealers, particularly in complying with the new or enhanced regulatory requirements that have been implemented over the past number of years.

This element of the proposal seems to be based on the faulty premise that a fee only model for advisor compensation would eliminate a source of potential conflict of interest through increased transparency. In fact, the opposite is true. In a fee based model the information investors receive is actually reduced, since investors are placed in the position of having to negotiate advisory fees with dealers directly and independently, with context as to what is reasonable, or what other investors are paying for similar services. This situation sits in stark contrast to the environment governing the distribution of mutual funds, which provides for comprehensive disclosure to the public and investors of all fees and commissions through the Simplified Prospectus, Fund Facts and Management Report on Fund Performance.

We would add that investors do not see a cost advantage in this model either. This is clear when the situation in Canada is compared to the United States, where the fee for service model dominates. Research demonstrates that once all factors are taken into account, mutual fund fees in Canada are on average comparable to those in the United States[5]. Further, for investors at the lower asset level, the all-in cost is in fact significantly lower in an embedded compensation model than a fee for service model.

The fee for service model has existed in Canada for many years, as do fund series that have been developed to fit these structures (namely funds that have lower or no trailing fee aspect). Advisors

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[5] Investor Economics and Strategic Insight, *Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios, A Canada-U.S. Perspective,* November 2012.

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who want to provide financial advice through a fee-based service model are readily able to do so and to make the case in its favour. In addition, fund manufacturers have the ability to structure their product offerings to address the needs of clients who prefer having a fee-based advisory relationship and many have done so. Investors who prefer to pay an additional fee for an advisory relationship have that option and the market will continue to evolve to develop the options clients have available in response to investor demand and open .

The guiding consideration to this discussion must be investor choice. Clients who are more comfortable investing in a fund where all the fees are included (and fully disclosed) in an environment where other options are widely available for comparison and all subject to extensive public scrutiny, should continue to be able to do so. Ultimately the goal should not be to limit freedom of choice for investors. Clients will not be well served by a proposal such as this that would eliminate one investment option in favour of another that may not be as beneficial to for them.

3. Conclusion

We are concerned about the overall tenor of the Discussion Paper, which seems to mirror some of the recent misinformed discussion in the media and elsewhere that implies that sales process that supports the Canadian mutual fund industry is somehow harmful and that the expenses associated with mutual funds are excessive. This is unfortunate, since in our view it does not reflect the reality.

As we have noted, although the paper proceeds on the basis that the relationship between advisors and their clients is subject to various conflicts of interest, on closer examination the evidence does not support this position. In fact there is and continues to be a close alignment in interests between clients and their advisors, which experience has clearly demonstrated has served the public well.

In short, it is unfair and inconsistent with the public interest to single out the mutual fund sector for distinctive treatment regarding embedded compensation within a larger financial services industry in Canada that, as a result of investor preference, is dominated by this model. We strongly support fair and unbiased disclosure to potential and existing investors for all financial products.

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We thank you for the opportunity to provide comments on the Discussion Paper. Please feel free to contact me if you wish to discuss this further or require additional information.

Yours truly,

INVESTMENT PLANNING COUNSEL INC.

Christopher Reynolds

Vice-Chairman, President and Chief Executive Officer