



Canadian Foundation *for*  
Advancement *of* Investor Rights

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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  
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**RE: Canadian Securities Administrators (“CSA”) Discussion Paper and Request for Comment  
81-407 *Mutual Fund Fees* (the “Consultation Paper”)**

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FAIR Canada is pleased to offer comments on the Consultation Paper issued by the CSA regarding the mutual fund fee structure in Canada.

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.

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### **EXECUTIVE SUMMARY:**

1. FAIR Canada is of the view that the mutual fund fee structure in Canada is in urgent need of reform and the necessary reforms go beyond improved disclosure to investors. While FAIR Canada supports Point of Sale disclosure and the Cost Disclosure and Performance Reporting Requirements (“**CRM2**”) as important initiatives, more needs to be done to protect investors.
  - Reforming mutual fund fees by banning third-party embedded commissions including banning trailing commissions on mutual funds sold through discount brokerages and direct from the manufacturer, needs to occur so that: Serious conflicts of interest, which are systemic and structural in nature and which lead to investment recommendations that provide higher compensation to the advisor while disregarding the costs to the consumer, will be significantly reduced;
  - Consumers will be able to determine the amount they pay for the operating costs of the mutual fund versus the costs they pay for advice;
  - Consumers will have more control over the costs they pay as they will
    - (1) know that they pay for “advice”;
    - (2) be able to compare the costs and services of different advisors; and
    - (3) be able to negotiate directly with their advisor as to the costs and the type of fee arrangement they will enter into;
  - Consumers will be more aware of the costs they pay (for the fund or for the advice) which will allow them to assess the value;
  - The fee structure of mutual funds, which is complicated and confusing to the average consumer, will be simplified and made more transparent; and  
Consumers will be better able to compare the costs of various mutual funds and will be able to compare the costs of mutual funds to other investment products such as exchange traded funds (“**ETFs**”).
2. Banning embedded commissions will lead to better investment recommendations for many consumers. If advisors are compensated directly by the clients they serve rather than the product manufacturers, they will no longer be incented by higher trailing commissions to sell high-fee products to their clients, and will be better able to provide recommendations that are in the best interest of the client.

3. Banning embedded commissions will allow consumers to make more informed investment decisions. If consumers know the price they are paying, they will be able to assess the value they receive for their fees and be empowered to make better decisions. This will result in better outcomes for consumers.
  4. Banning embedded commissions should lead to a more price-competitive market for mutual funds, which should lower the average fees paid by Canadians, which are currently among the highest in the world. If consumers end up paying less for their investments, they will improve their returns, thereby enabling them to accumulate more savings for their retirement or other financial goals. This is an important public policy objective of all governments in Canada.
  5. Banning embedded commissions should enhance the professionalism of the financial services industry and enhance public trust in the industry and financial markets. This would be of benefit to both consumers and dealers and advisers.
  6. The current mutual fund fee structure contains serious conflicts of interest which are not addressed by the Point of Sale initiative or CRM2. These conflicts result in inadequate consumer protection and inadequate consumer information. Given the concerns identified by the CSA, and in order to fulfill CSA Members' mandates to foster efficient capital markets and protect investors, there is no justifiable reason to wait and "...monitor and assess the effects of related regulatory reforms in Canada and around the world"<sup>1</sup> before considering any of these regulatory options further. We see no reason to wait until CRM2 comes into effect three years from now, and then to wait beyond that to see their effect, when those requirements do not meaningfully address the serious conflicts of interest that have been identified by the CSA in the Consultation Paper and that we discuss in this submission.
  7. FAIR Canada urges all members of the CSA to take immediate steps to address the serious concerns identified in the Consultation Paper and in this submission by banning third party commissions, including banning trailing commissions on mutual funds sold through discount brokerages and direct from the manufacturer.
  8. FAIR Canada also recommends that a statutory best interest standard be introduced, as being both feasible and highly desirable.
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## **1. THE IMPORTANCE OF GETTING MUTUAL FUND REGULATION RIGHT**

- 1.1. FAIR Canada is pleased with the depth and breadth of the Consultation Paper published by the CSA. We believe that the CSA has provided a good overview of the mutual fund industry in Canada and identified the main current issues arising from the mutual fund fee structure in Canada.

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<sup>1</sup> (2012) 35 OSCB 11233 at page 11234.

- 1.2. We note that the issues raised by the Consultation Paper with respect to mutual funds are not new and have been identified and discussed regularly in other reports, consultations, and in the media. For example, Glorianne Stromberg's 1995 investment fund regulation report noted:

"The single most difficult issue of all of the issues that have been raised in the context of investment funds is how to deal with situations involving conflicts of interest.

Situations which involve potential conflicts of interest arise in connection with every investment decision or other transaction where there is a reason to question whether the investment decision or other transaction was motivated by considerations other than what is in the best interests of the investment fund and its securityholders."<sup>2</sup>

Ms. Stromberg noted in that report at that time that this was not a new issue.

- 1.3. Early on in their evolution, mutual funds enlisted investment dealers as distribution arms and, in the process, created a system of charging clients that resulted in confusion about what was being paid for managing the fund versus selling the funds, and what component of fees pay for advice. FAIR Canada believes such confusion persists.
- 1.4. As noted by the CSA, research shows that retail investors are largely unaware of such fees but, when they are aware of them, it appears highly unlikely that they know how much they are paying for each of these "services".<sup>3</sup>
- 1.5. While we understand that trailing commissions are intended to provide payment for advice (whether advice is actually provided to investors is a separate question), we fail to understand why trailing commissions would then vary depending on the sales load charged. The lack of transparency and accountability as to whether these payments are for sales transactions or for advice further inhibits investors' ability to understand the fees they pay and to evaluate the value of the services they receive in return.
- 1.6. In principle, we question why the sale of a mutual fund would be considered to be any different than the purchase of a listed security. We do not believe that the transactions are materially different. Further, the after-service relating to the mutual fund is no different from the after-service related to a stock. Any ongoing fee charged by the broker or dealer on a portfolio of stocks in a given account is that broker or dealer's remuneration for monitoring the portfolio. The business model encourages that broker or dealer to provide good service with a view to conducting repeat business with a given investor. If a consumer were to invest exclusively in mutual funds, we believe it would make sense to pay a fee if ongoing monitoring of the portfolio occurs. The broker or dealer would earn a clear fee as a result of that service. **FAIR Canada believes that this model reflects the principle that consumers should not be paying substantial ongoing**

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<sup>2</sup> Glorianne Stromberg, "Regulatory Strategies for the Mid-'90s: Recommendations for Regulating Investment Funds in Canada" (1995), online: <[http://faircanada.ca/wp-content/uploads/2010/10/Stromberg\\_RegulatoryStrategies\\_Feb95.pdf?ac95e7](http://faircanada.ca/wp-content/uploads/2010/10/Stromberg_RegulatoryStrategies_Feb95.pdf?ac95e7)>.

<sup>3</sup> As noted in the Consultation Paper, the CSA Study and the IEF Study have found that most investors are not aware of trailing commissions and have little to no idea of how advisors can get paid, at pages 11252 to 11253.

**fees in perpetuity to a financial firm simply as a result of continuing to hold a mutual fund in an account. There is no reason why they should have to do so for mutual funds.**

### **Canada Has High Mutual Fund Fees**

- 1.7. **Independent academic research resoundingly supports the contention that mutual fund fees in Canada are among the highest in the world.**<sup>4</sup> While industry lobby groups challenge the findings of such studies, the arguments we have heard made in defense of high fees in Canada, for example, suggesting the comparisons are not “apples to apples” or suggesting that the size of the market in Canada inhibits economies of scale, are meritless. Each country’s mutual fund market will have their own idiosyncrasies and the studies note such factors in their reports. It is our understanding that all material information was incorporated into these independent, academic studies.
- 1.8. The impact of high fees on investor returns is significant. The longer the time horizon, the more dramatically fees impact investor returns. Costs are an important determinant of long-term returns from collective investments such as mutual funds.<sup>5</sup>

### **Regulators Should Examine Reasons for High Mutual Fund Fees in Canada**

- 1.9. The Consultation Paper does not attempt to provide any views as to why Canadian mutual fund fees are so high, although it does refer to the issue and examine the differences in mutual fund fee structures in four jurisdictions.<sup>6</sup> FAIR Canada recommends that regulators should consider examining the issue of why Canadian mutual fund fees are so high.
- 1.10. We note that a number of factors are listed in Annex I. FAIR Canada suggests that fund governance may also be a factor that should be reviewed as a possible reason for the high mutual fund fees in Canada. While other leading jurisdictions have a board of directors (and independent directors), Canada did not adopt that model and instead adopted the concept of the independent review committee, which FAIR Canada does not believe provides sufficient oversight. We do not suggest that the CSA delay in implementing the necessary reforms we recommend herein while examining this issue, but it should be pursued.
- 1.11. The Consultation Paper indicates that the typical maximum trailer fee is 1.5% in Canada (the highest of the four leading jurisdictions profiled) and that the asset-weighted average MER in Canada is also the highest of the four jurisdictions examined, at 1.93%.<sup>7</sup>

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<sup>4</sup> As noted in the Consultation Paper, such studies include: B.N. Alpert, J. Rekenhaller, "Morningstar Global Fund Investor Experience 2011 (March 2011); A. Khorana, H. Servaes, P. Tufano, *Mutual Fund Fees Around the World* (July 23, 2007).

<sup>5</sup> See the Securities and Exchange Commission's *Calculating Mutual Fund Fees and Expenses* (October 8, 2010), online: <<http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm>>. See also John Bogle's comments in *Lower fees: Slice your way to a more fruitful portfolio* (June 15, 2012) Globe and Mail online: <<http://www.theglobeandmail.com/globe-investor/personal-finance/lower-fees-slice-your-way-to-a-more-fruitful-portfolio/article4280020/>>.

<sup>6</sup> See Annex I of the Consultation Paper.

<sup>7</sup> See Annex I of the Consultation Paper at page 11279.

- 1.12. The Consultation Paper also explains the trend that an increasing amount of advisors' compensation is composed of trailing commissions. With more of the fees embedded (and effectively hidden), consumers are less aware that they are paying high fees.

### Costs Have Huge Impact on Canadians' Ability to Save

- 1.13. While it is difficult to empirically estimate the impact of agency costs on consumers, numerous reports have demonstrated the staggering impact of small differences in annual percentage costs to Canadians over the long term. **When the time value of money is factored in, even seemingly innocuous differences in consumer costs can have a huge impact on consumers' long term savings.**<sup>8</sup> For example, a study examining the consequences of higher fees demonstrated that a 1.1 percent increase in the effective expense ratio resulted in a decrease in savings of \$156,000 based on an annual contribution of \$10,000 per year for 40 years.<sup>9</sup> The person would have had an additional 28 percent total savings had their investment expense ratio been 1.1 percent lower.
- 1.14. Most consumers do not realize that trailing commissions are paid to their advisor by the manager of the mutual fund and that these payments continue for as long as they stay invested in the fund. Most consumers are also completely unaware of the impact of fees on their portfolios over the long term. Consumers are unaware of the importance of costs to their returns and, therefore, their ability to save for their retirement or other goals. Advisors do not appear to stress the importance of costs to their clients and the existing rules have not required them to do so.<sup>10</sup> As a result, little attention is paid to fees, and Canadians' savings are eroded over time.

### Proportion of Retirement Savings Held in Mutual Funds

- 1.15. At the end of 2011, 42% of Canadians' RRSP assets were held in investment funds.<sup>11</sup> As stated in the Consultation Paper, 62% of Canadians with savings or investments set aside hold mutual funds in their investment portfolios; this makes mutual funds the most commonly held investment product in Canada. The average Canadian household held 36.1% of its investable assets in mutual funds.<sup>12</sup> A recent Bank of Montreal survey shows

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<sup>8</sup> See, for example, <<http://www.milliondollarjourney.com/the-longterm-cost-of-higher-management-expense-ratios-mers.htm>>; <<http://www.which.co.uk/money/savings-and-investments/guides/different-types-of-investment/are-fund-charges-eating-into-your-returns/>>; and <<http://www.steadyhand.com/education/fees/>>.

<sup>9</sup> Keith Ambachtsheer and Rob Bauer, "Losing Ground – Do Canadian mutual funds produce fair value for their customers?" (Spring 2007), Canadian Investment Review 8, contents available online: <<http://arno.uvt.nl/show.cgi?fid=81991>> at page 12. This article summarized the findings of the study titled "Economies of Scale, Lack of Skill, or Misalignment of Interest? A Study of Pension and Mutual Fund Performance" by Bauer, Frehen, Lum, and Otten.

<sup>10</sup> See Consultation Paper at page 11253 regarding requirements to disclose trailing commissions or sales commissions and page 11259 which refers to the suitability process and notes that costs are not a specified factor in suitability.

<sup>11</sup> Investor Economics, "Mutual Fund MERs and Cost to Customer in Canada: Measurement, Trends and Changing Perspectives" (September 2012), online: <<https://www.ific.ca/Content/Document.aspx?id=7477&LangType=1033>> at page 8.

<sup>12</sup> Note that the unattributed figures in this paragraph come from page 11234 of the Consultation Paper.

that 72% of Canadians with RRSPs hold mutual funds within their RRSPs and mutual funds account for 31% of all holdings in RRSPs.<sup>13</sup>

- 1.16. In Canada, total mutual fund assets under management as of February 2013 were \$891.8 billion.<sup>14</sup> More than 12 million Canadians own mutual funds.<sup>15</sup> Data on the average account size for Canadians is not publically available. We do know that the average annual RRSP contribution is \$2,830 of the median Canadian retail investor<sup>16</sup> and that the average mutual fund balance per fund, as of December 2012, was \$17,926.
- 1.17. We note that mutual funds may be prevalent investments in the retirement accounts of Canadians but they are not necessarily well-understood. For example, while mutual funds are owned by many Canadians, one-in-two Canadians do not understand that mutual fund returns are not guaranteed.<sup>17</sup> They are also more frequently discussed as potential investments by advisors than other investments.<sup>18</sup>
- 1.18. Clearly, mutual funds are an investment product that is important to the retirement savings and financial security of Canadians. It is essential that they are regulated in a way that ensures that consumers are able to make informed decisions to provide them with the best possible financial outcomes.

### Shift of Burden of Retirement Savings to Individuals

- 1.19. There has been a noticeable shift, in Canada and elsewhere, of the burden of saving for retirement from employers to individuals. Further, life expectancy is rising and governments are reducing and coming under increasing pressure to further reduce old age benefits. Individuals are becoming increasingly responsible for ensuring their financial security in retirement, and some research shows they may be ill-prepared to fund their retirement.
- 1.20. These added pressures, combined with the prevalence of investment funds in Canadians' investment accounts and the significance of fees to investment returns, make

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<sup>13</sup> BMO Financial Group, "BMO Study: Mutual Funds Are Backbone of Canadians' RRSPs", online: <<http://newsroom.bmo.com/press-releases/bmo-study-mutual-funds-are-backbone-of-canadians--tsx-bmo-201302210854759001>>.

<sup>14</sup> The Investment Funds Institute of Canada, "IFIC Industry Overview" (February 2013), online: <<https://www.ific.ca/Content/Document.aspx?id=7565&LangType=1033>>.

<sup>15</sup> Speech by Joanne De Laurentiis (May 2, 2011) 10<sup>th</sup> Annual Compliance Forum, online: <<https://www.ific.ca/Content/Document.aspx?id=6592>>. Data from the 2012 CSA Investor Index, coupled with population figures from Statscan suggest this is somewhere around 12.5 million Canadians now.

<sup>16</sup> The median RRSP contribution in Canada in 2011 was \$2,830; the median RRSP contribution in Ontario in 2011 was \$2,900. See online: <<http://www.statcan.gc.ca/daily-quotidien/130211/dq130211a-eng.htm>>. The average RRSP contribution in Ontario in 2011 was just under \$6,000 – see <<http://www.statcan.gc.ca/daily-quotidien/111202/t111202b1-eng.htm>>.

<sup>17</sup> Innovative Research Group, "2012 CSA Investor Index" (October 16, 2012), online: <[http://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL\\_EN.pdf](http://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf)> at page 45.

<sup>18</sup> The Brondesbury Group, *Investor behaviour and beliefs: Advisor relationships and investor decision-making study* (2012) (prepared for the Investor Education Fund), online: <<http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf>>, at page 14.



the regulation of mutual fund fees an essential public policy component of financial security in retirement in Canada.

## 2. THE PROBLEMS WITH MUTUAL FUND FEES

2.1. FAIR Canada believes that there are two fundamental issues arising as a result of the current mutual fund fee structure in Canada:

- (i) Compensation Drives Behaviour: Conflicted remuneration (that is, misaligned incentives) influence recommendations to the detriment of financial consumers (unbeknownst to consumers); and
- (ii) Unhealthy Competition: Conflicted remuneration inhibits healthy competition for investors' business by:
  - (1) inhibiting informed consumer choice,
  - (2) impeding consumers' evaluation of the value of the services they receive against the costs they pay, and
  - (3) inhibiting effective competition amongst product manufacturers to lower the fees that consumers must pay for their investments and instead allowing them to compete for advisors' business through increased trailing commission payments to advisors.

2.2. **We believe that the CSA must take steps to better align advisors' recommendations with the best interests of their clients and encourage healthy price competition between mutual funds to offer investors value for fees.**

2.3. As noted in FAIR Canada's submission regarding the consideration of a best interest standard for advisers and dealers<sup>19</sup>, we have great difficulty in understanding how an adviser or dealer (or their representative) required to act in the client's best interest could accept payments from a third party and fulfill their duty to the client. **In our view, more transparency with respect to fees (both before purchase and on an annual basis) is essential, but would not adequately address the conflicts that are presented by third-party remuneration.**

2.4. We also question why cost was never an explicit component of a "suitability" assessment. Given that fees reduce returns to investors, and numerous studies have demonstrated the negative relationship between fees and returns<sup>20</sup>, FAIR Canada believes that fees are an important consideration in evaluating the appropriateness of two otherwise-similar mutual funds or other investments.

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<sup>19</sup> FAIR Canada submission to CSA Consultation Paper 33-403, Statutory Best Interest Standard, available online: <<http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-Submission-re-CP33-403-Statutory-Best-Interest-Duty.pdf?ac95e7>>.

<sup>20</sup> Tess Wilkinson-Ryan & Jill Fisch, "An Experiment on Mutual Fund Fees in Retirement Investing" (June 2012), online: <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2086766](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2086766)> at page 4; Morningstar FundInvestor, "How Expense Ratios and Star Ratings Predict Success" (August 2010).



### **3. CONFLICTS OF INTEREST**

3.1. Various conflicts of interest are inherent in the structure of mutual fund fees in Canada. These include the following, which will each be discussed in detail below:

- conflicts between the consumer's interests and the advisor's;
- conflicts between the firm employing the advisor and the consumer; and
- conflicts between mutual fund managers and their funds' investors.

#### **Conflicts between Investors' Interests and those of Advisors**

- 3.2. A conflict of interest arises where advisors are required to choose between (1) the best recommendation for a client, and (2) a recommendation that, while "suitable" under the current interpretation of suitability, is more expensive for the client but provides greater remuneration for the advisor.
- 3.3. Similarly, where advisors must choose between a recommendation that would help them reach a targeted sales goal (or other target) and another recommendation that would be more beneficial for the client, a conflict of interest arises between the interests of the client and the interests of the advisor.

#### **Conflicts between the Interests of Firms and Investors**

- 3.4. Investment firms exist to generate profits for their owners. Consumers' interests are to save and earn money for their own future needs. Investment firms often attract customers through marketing and advertising that suggest that they look out for their clients and that they will "take care of them" and firms profit from the business such representations generate, irrespective of whether they actually act in the consumer's best interest.
- 3.5. Where firms prioritize their profitability over the needs of their clients and, at the same time, lead consumers to believe they are acting in the consumers' best interests, a serious conflict of interest arises. Investment firms, which are often also mutual fund manufacturers, determine remuneration structures for the individual advisors who make recommendations to clients. Structurally, firms have the power to incentivize sales of particular products that might be less optimal than others for consumers, even though consumers are induced to trust the recommendations made to them. Firm culture and the resulting compensation structure will have a significant impact on the firm's customers.

#### **Conflicts between mutual fund managers and their funds' investors**

- 3.6. Mutual fund managers are compensated on the basis of assets under management. They are paid a management fee calculated as a percentage of the total assets invested in the fund. Such a compensation structure incentivizes managers to attract greater amounts of investment in order to increase their compensation. This could be accomplished through strong performance and greater returns to the fund's investors,

but much literature suggests that investor funds may also be attracted through an incentivized sales force<sup>21</sup>, paid to direct these funds into investment funds that pay trailing commissions under the pretence of paying for advice for investors, but instead effectively operating as a sales commission. Consumers who are invested in the fund do not benefit.

### Regulators Must Address Conflicts of Interest

- 3.7. In aggregate, the above-mentioned interests that conflict with consumers' interests can significantly influence investment outcomes, to the detriment of consumers. The expectations gap between the duty that is owed to investors under securities regulation and what consumers expect demonstrates a real lack of consumer understanding of the impact of conflicts of interest on investment recommendations.

### Remuneration Drives Recommendations

- 3.8. Real and perceived conflicts of interest compromise the quality of investment recommendations. They misalign the interests of advisors and firms from those of their clients. Bias toward an advisor or firm's own interest can result in higher costs and less-optimal recommendations to consumers. Consumers have a very low awareness of (i) the existence of conflicts of interest<sup>22</sup>, and (ii) the potential impact of conflicts of interest<sup>23</sup>. In addition, consumers do not have the requisite knowledge to appropriately factor the impact of a conflict of interest into their evaluation of the advice they receive.
- 3.9. Not only are consumers generally unaware of the conflicts of interest that impact the investment recommendations they receive, but they are not equipped to factor such information into their investment decisions. **Academic research shows that investors do not have the knowledge or the experience to factor disclosed conflicts of interest into their evaluation of conflicted advice they receive.**<sup>24</sup>
- 3.10. Further, while we are concerned about overt bias, "...considerable research suggests that bias is more frequently the result of motivational processes that are unintentional and unconscious."<sup>25</sup> Even those advisors who want to provide advice that is in the best interest of their clients are deterred from doing so as a result of the compensation structure in place. Often, the effects on consumers are unintended by advisors:

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<sup>21</sup> Susan E.K. Christoffersen, Richard Evans, and David K. Musto, "What do consumers' fund flows maximize? Evidence from their brokers' incentives" (March 8, 2012), *Journal of Finance*.

<sup>22</sup> *Supra* note 18; Benjamin N. Alpert and John Rekenhaller, *Morningstar Global Fund Investor Experience 2011* (March 2011), online: <<http://corporate.morningstar.com/us/documents/ResearchPapers/GlobalFundInvestorExperience2011.pdf>>; The Strategic Counsel, *A Report to The Joint Standing Committee on Retail Investor Issues - Retail Investor Information Survey* (June 2009), online: <[http://www.osc.gov.on.ca/static/\\_/JSC/jsc\\_retail-investor-info-survey.pdf](http://www.osc.gov.on.ca/static/_/JSC/jsc_retail-investor-info-survey.pdf)>; Lori Bottrell and Ed Weinstein, *Focus Groups with Retail Investors on Investor Rights and Protection* (April 2011) (prepared for the Investor Advisory Panel of the Ontario Securities Commission), online: <[http://www.osc.gov.on.ca/documents/en/Securities-Category1-Comments/com\\_20110427\\_11-765\\_ananda.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category1-Comments/com_20110427_11-765_ananda.pdf)>.

<sup>23</sup> *Supra* note 18; *supra* note 22 (The Strategic Counsel); and *supra* note 22 (Bottrell and Weinstein).

<sup>24</sup> Daylian M. Cain, George Loewenstein, and Don A. Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest" (2005) 34(1) *J. Legal Stud.* 1.

<sup>25</sup> *Ibid.* at page 5.

Well-meaning professionals often think that they are being objective when in fact their advice partly services their own interest. If the public better appreciated this fact, perhaps disclosure would serve as a better warning. As it stands, most audiences think that their advisers would never intentionally mislead them, conflict or no conflict. Even if this were true, bad advice can be given unintentionally: good intentions do not ensure good advice.<sup>26</sup>

### **Incentives Negatively Affect Outcomes**

- 3.11. Research based on U.S. data confirms our expectation that advisor incentives impact investment decisions. Specifically, the research found that “...brokers’ incentives play a significant role in both flows and performance” where new investment increases with the load paid to the broker and future performance decreases with the broker’s payment from the load. Specifically, the paper found that “[r]evenue sharing also increases new investment....” The paper also cites other literature on 12b-1 fees (distribution and service fees charged by mutual funds in the U.S., including fees for marketing and compensation for brokers, which are charges included in the MER in Canada), “which have been shown to relate positively to net flows”. Advisor incentives negatively impact consumer outcomes.

### **Disclosure is Inadequate for Managing Conflicts**

- 3.12. According to the G20 High-Level Principles on Financial Consumer Protection,
- Where the potential for conflicts of interest arise, financial services providers and authorised agents should endeavour to avoid such conflicts. When such conflicts cannot be avoided, financial services providers and authorised agents should ensure proper disclosure, have in place internal mechanisms to manage such conflicts, or decline to provide the product, advice or service.<sup>27</sup>

Avoiding conflicts of interest (by removing certain conflicts altogether, for instance) is the preferred approach to controlling for conflicts of interest.

- 3.13. Other jurisdictions have realized that disclosure is an ineffective approach to managing conflicts of interest. For example, an Australian inquiry into financial products and services found:

A significant conflict of interest for financial advisers occurs when they are remunerated by product manufacturers for a client acting on a recommendation to invest in their financial product... These payments place financial advisers in the role of both broker and expert adviser, with the potentially competing objectives of maximising remuneration via product sales and providing professional, strategic financial advice that serves clients' interests. The committee received considerable evidence on the nature and

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<sup>26</sup> Paavan Gami, “Conflict of interest disclosure ‘no panacea’” (February 21, 2012), Yale Daily News, quoting Dr. Daylian Cain, available online: <<http://yaledailynews.com/blog/2012/02/21/conflict-of-interest-disclosure-no-panacea/>>.

<sup>27</sup> Organization for Economic Co-operation and Development, *G20 High-Level Principles on Financial Consumer Protection* (October 2011), online: <<http://www.oecd.org/daf/financialmarketsinsuranceandpensions/financialmarkets/48892010.pdf>>.

effect of these conflicts, including on the quality and cost of advice, and whether it is possible for them to be managed appropriately...

**Evidence to the committee strongly suggested that the current disclosure requirements had not been an effective tool for managing conflicts of interest.<sup>28</sup> (emphasis added)**

- 3.14. Research suggests that disclosure would be more effective when recipients of advice have expertise or experience to help them assess the potential effects of the disclosed conflicts of interest.<sup>29</sup> It is noted that “[f]or disclosure to be effective, the recipient of advice must understand how the conflict of interest has influenced the advisor and must be able to correct for that biasing influence.”<sup>30</sup> This is telling about the usefulness of such disclosure to unsophisticated recipients, such as individual consumers, who are in the greatest need of protection.
- 3.15. Canadian evidence suggests that consumers “believed that their advisor would look out for their best interest regardless of how the advisor was paid. ...[H]alf of investors could not form a view about conflict of interest. ...Among the half of investors with an opinion on conflict of interest, three-quarters believed that their advisor would look out for their best interest regardless of how the advisor was paid.”<sup>31</sup> Numerous surveys of Canadian financial consumers demonstrate a blind trust in financial advisors and a near-complete disregard for any effect that a conflict of interest may have on the advice provided. In our view, most Canadian consumers do not have the requisite knowledge and experience to sufficiently adjust for the conflict of interest that is disclosed.<sup>32</sup>
- 3.16. FAIR Canada recognizes that industry and regulators might prefer the disclosure approach to managing conflicts of interest in an ‘inherently conflictual’ industry because it generally involves little disruption to the status quo (i.e. it does not necessitate a re-evaluation of business models and therefore is easier for regulators given industry opposition to reforms). Also, as noted in “The Dirt on Coming Clean”, “[d]isclosure offers a further benefit to both advisors and to policy makers: it diminishes both parties’ responsibility for adverse outcomes.”<sup>33</sup> FAIR Canada is of the view that a “disclose and move on” approach is not acceptable

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<sup>28</sup> Parliamentary Joint Committee on Corporations and Financial Services (Australia), *Inquiry into financial products and services in Australia* (November 2009), online:

<[http://www.aph.gov.au/Parliamentary\\_Business/Committees/Senate\\_Committees?url=corporations\\_ctte/completed\\_inquiries/2008-10/fps/report/index.htm](http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/completed_inquiries/2008-10/fps/report/index.htm)> at paras. 5.29-5.30 and 5.53.

<sup>29</sup> *Supra* note 24 at page 20.

<sup>30</sup> *Supra* note 24 at page 3.

<sup>31</sup> *Supra* note 18.

<sup>32</sup> This is as a result of the combination of: (1) a lack of awareness of conflicts of interest, and (2) the low overall investment knowledge of Canadians. The *2012 CSA Investor Index* (see *supra* note 17) found a low awareness of how Canadians’ financial advisors are compensated and that “...overall investment knowledge of Canadians is low, with 40 percent of Canadians failing a general investment knowledge test.”

<sup>33</sup> *Supra* note 24 at page 3.

## Perverse Effects of Disclosure

3.17. A considerable amount of research has been conducted regarding the effects of disclosure, both within the financial services context and more broadly. These behavioural studies have proven the perverse effects of disclosing conflicts of interest. As summed up in the abstract to “The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest”:

Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors’ conflicts of interest are disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse.<sup>34</sup>

3.18. FAIR Canada believes that the best way to protect consumers from conflicts of interest arising in the advisor-client context is to ban conflicted remuneration. In particular, third-party commissions should be prohibited. In our view, third-party commissions contribute significantly to the opaqueness of cost information and provide few, if any, tangible investor benefits.

3.19. **In theory, third party commissions are based on the presumption that such commissions pay for “ongoing” advice to the investor, but FAIR Canada questions whether such advice is provided, and, where it is, how valuable it is to the consumer. Third-party commissions inhibit healthy competition, in that they encourage anti-competitive behaviour between issuers (or their agents) to pay higher commissions to a sales force in order to sell more of their product. Instead of issuers competing on the basis of lowest costs to consumers, they compete to win the business of advisors, thus driving up the costs of investing to unsophisticated consumers.**

3.20. **In FAIR Canada’s view, the prohibition of conflicted remuneration would improve outcomes for consumers by:**

- (i) reducing compensation bias in recommendations;**
- (ii) reducing costs to investors through enhanced price competition;**
- (iii) avoiding unintended consequences of disclosure, such as increased trust and reliance by consumers and moral license by advisors; and**
- (iv) reducing the distribution of inferior products which are sold through the payment of higher-than-average trailing commissions.<sup>35</sup>**

3.21. Furthermore, reducing conflicts of interest will require issuers and their distributors to focus on the quality of their products. We expect that banning conflicted remuneration would “weed out” the less-convincing products. A compensation system that was

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<sup>34</sup> *Supra* note 24.

<sup>35</sup> Portus is one example of high fees motivating a sales force to sell poor products.

designed to be product-neutral would reduce conflicts of interest and provide better advice for financial consumers. This would enhance the professionalism of the financial services industry and enhance public trust in the industry.

- 3.22. Impartial advice about mutual funds is essential to the financial well-being of Canadians. FAIR Canada believes that, in order to encourage the impartiality of advice, embedded commissions must be banned.

#### **4. EMBEDDED COMMISSIONS INHIBIT PRICE COMPETITION**

- 4.1. Competition is essential to ensuring efficiency in any market. Perfect knowledge about product quality, price, and cost is an important characteristic of a perfectly competitive market.<sup>36</sup> Embedded commissions inhibit investor awareness of and knowledge about the price they pay for mutual funds and for purported financial advice. Embedded commissions also inhibit knowledge about product quality, price and cost because they cause conflicts of interest between the sources of such information (i.e. advisors and firms) and purchasers (i.e. consumers). This lack of competition leads to high costs for Canadian consumers of financial products. Embedded commissions therefore impede the proper functioning of our market.
- 4.2. Research conducted in respect of the Fund Facts document (specific to mutual fund and segregated fund information) found an interesting reaction from advisors with respect to commission language proposed for the Fund Facts document. “Advisors argued that commission practices across Canada vary so widely that it is hard to explain them clearly and succinctly to investors.”<sup>37</sup> We question how investors could be expected to make informed decisions if commission practices are so difficult to explain.
- 4.3. According to a study by Investor Economics for the mutual fund lobby group, the Investment Funds Institute of Canada, “[c]ompetition, if judged by the number of managers, the number of individual funds and the number of advisors able to sell mutual funds, has remained intense.”<sup>38</sup> While we agree that this is one characteristic of a competitive market FAIR Canada disagrees that this is indicative of a competitive mutual fund market in Canada. In our view, the large number of managers, funds and advisors is more likely indicative of the excessive profitability of the mutual fund business.
- 4.4. Competition in the mutual fund industry, like other industries, should be measured by indicators such as low costs and high product quality. Given the high costs of mutual funds in Canada, the questionable quality of many high-cost funds, evidence of how conflicted remuneration influences fund flows, and the public policy importance of

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<sup>36</sup> Economics Online, <[http://www.economicsonline.co.uk/Business\\_economics/Perfect\\_competition.html](http://www.economicsonline.co.uk/Business_economics/Perfect_competition.html)>.

<sup>37</sup> Research Strategy Group, “Fund Facts Document Research Report” (October 25, 2006) (prepared for the Ontario Securities Commission), online: <<http://www.spsc.gov.sk.ca/adx/aspx/adxGetMedia.aspx?DocID=2382,2288,257,105,81,1,Documents&MediaID=3523&Filename=81-406-appendix5-june15-07.pdf>> at page 47.

<sup>38</sup> *Supra* note 11.



adequacy of retirement savings, we believe that regulators need to facilitate and encourage price competition in the investment fund industry.

#### Investors Do Not Know Costs of Advice – Embedded Costs Problematic

- 4.5. Investment fund lobby groups routinely present “reports” through which they attempt to convince regulators, advisors, investors and other stakeholders that investors receive value for the costs they pay. Often these are based upon perceptions by investors who have advisors (which is highly subjective and self-selecting evidence), do not appear to determine whether people actually know what they pay, and likely is attributable in part to confirmation bias. While some studies suggest some correlation between accumulated wealth and advice, these studies do not attempt to compare the amount of fees investors pay to the services they supposedly receive in return. **Further, the results of independent academic studies “imply that financial advisors end up collecting more in fees and commissions than any monetary value they add to the account. This raises the further question of whether advisors overcharge and should be regulated.”**<sup>39</sup>
- 4.6. Considerable investor research demonstrates that consumers are far less aware (if they are aware at all) of embedded fees. A large majority of consumers are unaware of how advisors can be paid, and many are under the impression that “advice” is free. As noted in research undertaken for the Investor Education Fund (“IEF”), “[i]nvestors have little or no idea about how advisors can get paid.”<sup>40</sup>
- 4.7. Consumers’ trust in and reliance upon advisors to make recommendations in their best interest results in a widespread disregard of fees in making investment decisions. This trust was demonstrated in the IEF’s survey, which found that
- [i]nvestors trust their advisor to provide advice that benefits the client first. This trust is underpinned by a belief that their advisor has a legal responsibility to ‘put the client’s best interest first’. With this as a foundation of investor belief, investors find little reason to be concerned about fees, and perhaps as a result, fewer than half of advisors disclose what they are paid.<sup>41</sup>
- 4.8. Embedded commissions make it very difficult for investors to accurately estimate how much they will pay in fees over time. Embedded fees inhibit informed consumer decision-making and hamper investors’ evaluation of the value they receive for the costs they pay. Often, investors are completely unaware that they pay for advice, because it is paid by the investment fund manager out of the fund’s assets.
- 4.9. Various studies suggest that the further removed a transaction is from cash, the less price-sensitive consumers are about the costs.<sup>42</sup> By charging trailing commissions at the

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<sup>39</sup> Andreas Hackethal, Michael Haliassos, and Tullio Jappelli, “Financial Advisors: A Case of Babysitters” (July 6, 2009), online: <<http://www.econ.ceu.hu/download/BESS/11Sept09.pdf>> at page 24.

<sup>40</sup> *Supra* note 18 at page 2.

<sup>41</sup> *Supra* note 18 at page 2.

<sup>42</sup> Drazen Prelec and Duncan Simester, “Always Leave Home Without It: A Further Investigation of the Credit-Card Effect on Willingness to Pay” (June 8, 2000) *Marketing Letters*, 2001. Dan Ariely has also found that “cheating is a lot easier [morally and ethically] when it’s a step removed from money.” See Dan Ariely, “Predictably Irrational” (New York: 2008) Harper Collins Publishers at page 297.



fund level, consumers are much less likely to be aware of such fees than by paying directly. Even consumers who are aware of such fees feel less “pain” than if they were to be charged directly and thus are less savvy purchasers.

- 4.10. As noted in FAIR Canada’s submission regarding a best interest duty, many investment service providers pass themselves off as acting in a client’s best interest when in fact they do not and are not legally obliged to do so. This disadvantages other advisors who do meet a best interest standard in their daily activities but are unable to differentiate their services to potential clients:

In equilibrium, naive customers underestimate the likelihood with which they end up purchasing [a product] that generates higher profits for the respective financial institutions and for the intermediary than a more basic offering (or no purchase). Even though customers appear not to pay for advice, in reality they are thus seriously shortchanged through biased advice and higher product prices, in the form of higher management fees on investment products... **With naive customers, there is a clear benefit of policy intervention that requires firms to make customers pay directly for advice...** In fact, in the absence of policy intervention, **when the market is populated mostly by naive customers, firms could generate higher profits by targeting exclusively naive customers rather than serving the whole market with a non-exploitative offer.**<sup>43</sup>  
[emphasis added]

- 4.11. In FAIR Canada’s view, the above quote and the findings of the report “Financial Advisor: A Case of Babysitters”, suggest that a more cost-effective and efficient means of encouraging savings by Canadian consumers (for example, policy that encourages regular contributions to a low-cost investment portfolio) would be preferable to continuing to pay high costs for biased financial advice. Various stakeholders have called for reforms to the retirement income system in Canada to address the issue of retirement income inadequacy, including proposals for a national supplementary pension plan and expanding the Canada Pension Plan.<sup>44</sup> While some evidence suggests that investors indicate a preference for paying through embedded commissions, FAIR Canada believes that public policy should provide for informed consumer choice and healthy price competition and remove structures that impede a properly functioning market. Ensuring that consumers know what they pay for their investments and, importantly, how much they pay for advice would support financial consumers in

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<sup>43</sup> Roman Inderst and Marco Ottaviani, “How (not) to pay for advice: A framework for consumer financial protection” (August 2011), online: <[http://www.wiwi.uni-frankfurt.de/fileadmin/user\\_upload/dateien\\_abteilungen/abt\\_fin/Dokumente/PDFs/Allgemeine\\_Dokumente/Inderst\\_Downloads/Finance/How\\_not\\_to\\_pay\\_for\\_advice.pdf](http://www.wiwi.uni-frankfurt.de/fileadmin/user_upload/dateien_abteilungen/abt_fin/Dokumente/PDFs/Allgemeine_Dokumente/Inderst_Downloads/Finance/How_not_to_pay_for_advice.pdf)> at page 4. Note that in this paper, “naïve” investors were those who “fail to adequately take into account the potentially self-interested nature of advice”. In FAIR Canada’s view, based on the extensive investor surveys referred to elsewhere in this submission, this would describe a majority of Canadian investors.

<sup>44</sup> The provincial-territorial Steering Committee of Ministers on Pension Coverage and Retirement Income Adequacy released a report dated January 2010 entitled “Options for Increasing Pension Coverage Among Private Sector Workers in Canada”, available online at [http://www.fin.gov.bc.ca/pension\\_plan\\_options\\_paper.pdf](http://www.fin.gov.bc.ca/pension_plan_options_paper.pdf). Federal-Provincial-Territorial Ministers of Finance created a Research Working Group on Retirement Income Adequacy. In December 2010, Finance Minister Flaherty opted to support the Pooled Registered Pension Plans (PRPPs) to be offered by financial institutions.

performing a true evaluation of the value of advice and would encourage competition to provide good value for consumers of financial products.

- 4.12. **We believe that the direct payment of fees for advice is essential to real price competition in the investment fund industry. Consumers should agree to the fees in advance, and should understand, in advance, the services the advisor will provide in exchange for those fees. We believe that this will foster healthier competition in the mutual fund industry.**
- 4.13. The current system of embedded fees does not come close to allowing consumers to negotiate directly with their advisor what fees they will pay for advice and, therefore, there is no ability for the investor to have any control over that cost. This also inhibits effective price competition.

## **5. POTENTIAL REFORMS SUGGESTED BY THE CSA**

- 5.1. FAIR Canada supports the implementation of a statutory best interest duty for advisers and dealers and the banning of conflicted remuneration, including the banning of embedded commissions for mutual funds, including at discount brokerages or direct from manufacturers, as this would be highly desirable and feasible. We also make recommendations below which can function as interim steps that could be taken until such reforms are implemented.
- 5.2. Below, we set out each of the proposed changes suggested by the CSA and provide our comments.

### **CSA Proposal #1: Advisor Services to be Specified and Provided in Exchange for Trailing Commissions**

- 5.1. Under the current rules, advisors are not obligated to provide any specific services or personalized or generalized advice whilst collecting the annual trailing commission. The CSA suggests implementing a reform which would require advisors to provide certain specified services to their clients in return for collecting trailing commissions. The purpose of the trailing commission would be defined and disclosed to investors. Advisors and their dealer firms would be required to “record and monitor the nature, extent and frequency of the services provided to mutual fund investors”<sup>45</sup>, and “an advisor would be prohibited from collecting a trailing commission if it was determined that the services were not being delivered to investors.”<sup>46</sup>
- 5.2. *Fails to Address True Purpose of Trailing Commissions* - FAIR Canada does not support this proposed reform for a number of reasons. Firstly, the predominant purpose of the trailing commission has not been to provide services (including advice) to the investor but to provide an ongoing sales commission to the dealer and advisor for selling the mutual fund. The suggested change would mask its true purpose.

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<sup>45</sup> Consultation Paper at page 11269.

<sup>46</sup> Consultation Paper at page 11269.

- 5.3. The purported purpose of the trailing commission is a very fluid concept and in reality is a meaningless construct used by the industry – is it an administrative fee, a fee for advice (whilst little to none may be provided), or an ongoing sales commission. With no definition existing in securities regulation until the recent cost disclosure and performance reporting requirements, industry has been free to characterize the trailing commission as it sees fit and its intended purpose changes with each recharacterization.
- 5.4. *Fails to Address the Problem* - Secondly, and more importantly, this proposed reform would not address the conflicts of interest and misaligned incentives that exist between the mutual fund manufacturer and the consumer and between the sales representative and the consumer. Alignment of incentives and avoidance of conflicts of interest are extremely important to facilitate better outcomes for consumers and ensure that consumers are provided with recommendations that are in their best interest. If advisors are not incented through ongoing trailing commission payments to put consumers in certain investments funds over others, and can provide objective recommendations, incidents of mis-selling will likely be greatly reduced.
- 5.5. *Fails to Improve Price Competition* - Thirdly, this proposed reform would not facilitate or enhance price competition. The cost of advice and other services would still be set by the mutual fund manufacturer and there would not be any way for the investor to negotiate the amount of the advice fee or for dealers or their sales representatives to compete with other dealers on the cost of the ongoing advice fee. In addition, its continued opaqueness would impede a consumer's ability to evaluate whether they receive value for the fees that they pay.
- 5.6. *Difficult for Regulators to Oversee* - Finally, such a requirement would be extremely difficult for regulators to manage and oversee and would require additional compliance reviews being conducted by the self-regulatory organizations (“SROs”) (the Investment Industry Regulatory Organization of Canada (“IIROC”) and the Mutual Fund Dealers Association of Canada (“MFDA”)) and securities commissions, including contacting consumers to ensure that services being recorded as being performed are in fact being performed. Regulators should not create a regime that is difficult to police and that unnecessarily consumes scarce regulatory resources.

### **CSA Proposal #2: A Standard Class for DIY investors with no or reduced trailing commission**

- 5.7. The CSA proposes that every mutual fund could have a low-cost ‘execution only’ series or class of securities available for direct purchase by investors. The CSA proposes that the low-cost series would have no or a nominal trailing commission given that DIY investors have not sought advice. **FAIR Canada notes that it is not simply the case that DIY investors have not “sought” advice, but that current IIROC Dealer Member Rules do not permit discount brokerages to provide recommendations.<sup>47</sup> Current rules do not require discount brokerages to ensure that an order is suitable to a particular customer.**

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<sup>47</sup> See Investment Industry Regulatory Organization of Canada Dealer Members Rules 3100 and 3200 and, in particular, Dealer Member Rules 3200(3)(a).

- 5.8. FAIR Canada supports requirements that mutual funds have a series or class that has no trailing commission. In our view, a wholesale ban of trailing commissions should be implemented, as noted above, but requiring a series or class that has no trailing commission would be a temporary improvement that could be implemented immediately.
- 5.9. FAIR Canada does not see why there should be a nominal trailing commission associated with execution-only series of mutual funds given that no advice is provided and, if nominal trailing commission were permitted, the ongoing “nominal” trailing commission would continue to be charged every year for as long as the consumer holds the fund and would be a continued drag on the consumer’s return. **At a minimum, mutual funds with no trailing commission should be available to retail investors, including at discount brokerages and directly from mutual fund manufacturers.**
- 5.10. Consumers who wish to do it themselves are currently forced to pay trailing commissions when an “F” class fund is not available, even when they expressly request to be offered a version of the fund without a trailing commission. Even when an “F” fund class exists, DIY investors may be told it is not offered through the discount brokerage but is only available through an advisor (where it will be offered if the consumer agrees to compensate the advisor based on a percentage of the consumer’s assets under management (i.e. through a fee based account). **FAIR Canada agrees that mutual funds should have a no trailing commission, ‘execution only’ series available for direct purchase by consumers (including through a discount brokerage or direct from the mutual fund manufacturer. FAIR Canada also recommends, as an interim measure, that all firms that offer a particular mutual fund be required to offer the “F” class version of the fund (whether through a fees-based account or otherwise).**
- 5.11. **We recommend that these changes be implemented immediately.** These changes would benefit consumers as they would no longer be paying for advice they are not getting and would therefore realize immediate cost benefits. It would also provide investors who are aware of trailing commissions with a choice of whether to pay for embedded advice through an advisor or purchase the execution only mutual fund directly through the manufacturer or through a discount brokerage. Finally, it would allow investors the option of purchasing an “F” class version of a fund through their advisor. We believe that requiring a series or class with no trailing commission would be an interim step which would encourage advisors to consider better aligning their business model with the interests of their clients.
- 5.12. Alongside these reforms, **we recommend that consideration be given to permitting registrants of dealers who are restricted in the investment products they can sell (such as mutual fund dealers) to become registered to sell other collective investment products, such as ETFs, provided they meet the necessary level of proficiency, so that they can better meet consumers’ needs and improve outcomes for consumers.**<sup>48</sup> Many consumers are unaware of the limits on what their advisor can sell based on the

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<sup>48</sup> *Supra* note 18 at page 10.

advisor's licensing and registration.<sup>49</sup> Consumers can therefore go for a long period of time without realizing that the advisor has not recommended a certain type of product because he or she is not licensed or registered to sell it.

- 5.13. These reforms would level the playing field with respect to access to mutual funds through discount brokerages as there have been instances where funds that do not pay trailing commissions have been refused carriage by certain discount brokerages.<sup>50</sup>

***FAIR CANADA RECOMMENDATION: We recommend, as a temporary measure until a complete ban on trailing commissions is implemented, that an execution only series or class of mutual fund which has no trailing commission be required to be offered at discount brokerages or direct from the manufacturer. FAIR Canada also recommends that all firms that offer a particular mutual fund be required to offer the "F" class version of the fund which does not have a trailing commission (whether through a fees-based account or otherwise).***

### **CSA Proposal #3: Unbundle the Trailing Commission from the Management Fee and Have it as a Separate Asset-Based Fee**

- 5.14. The CSA proposes the unbundling of the trailing commission component of a mutual fund's management fee and charging and disclosing it as a separate asset-based fee to the fund in order to enhance the transparency of the fund and in order to make the trailing commission an expense of the fund and limit what it can be used for.<sup>51</sup>
- 5.15. This proposed reform is similar to current regulation in the U.S., where investment companies that pay trailing commissions have asset-based 12b-1 fees. The 12b-1 fee is intended to cover the cost of trailing commissions and other distribution-related services. The rule requires that the directors consider the 12b-1 plan and conclude "that there is a reasonable likelihood that the plan will benefit the company and its shareholders."<sup>52</sup> It also requires that the board receive quarterly reports of all amounts expended under the plan and the purposes for which the expenditures were made. Plans must be approved by the board/independent directors, and any material increase in amounts payable under a 12b-1 plan must be approved by the board, the independent directors, and the fund's shareholders.
- 5.16. A purported advantage associated with this proposed reform would be that increases in the separate asset-based trailer fee charged to a mutual fund would be subject to shareholder approval in the same way that the management fee is subject to such approval under current mutual fund rules and would be subject to review by the fund's independent review committee.

<sup>49</sup> *Supra* note 18 at page 10.

<sup>50</sup> RBC Direct Investing ceased to offer funds sponsored by Leith Wheeler, Mawer and Steadyhand. The move was described by RBC as a "business decision," and it appears that it reflects the fact that the funds offered by the firms do not pay trailers and thus RBC does not receive any trailing commission revenue from their sale. See <<http://cawidgets.morningstar.ca/ArticleTemplate/ArticleGL.aspx?id=573716>>.

<sup>51</sup> Consultation Paper at page 11269.

<sup>52</sup> Consultation Paper at page 11269 re Rule 12b-1(e).

- 5.17. The proposed reform suggested by the CSA is not accompanied by any suggested reform of the governance structure of mutual funds, such as requiring oversight by an independent board of directors in the place of the current Canadian approach of having an independent review committee (which falls short of the independent oversight required by other leading jurisdictions). We see it as problematic to suggest an oversight model to control fees while not reforming the Canadian structure of mutual fund governance.
- 5.18. While it would be possible to identify the management fee separately from the trailing commission in this proposal, and increases would be subject to security holder approval, FAIR Canada does not believe that this proposed change would be effective in lowering mutual fund costs (which are too high), it would not address the conflicts of interest which currently exist, and it would not lead to more price competition since the trailing commission would still be embedded in the product and there would be little incentive to lower it. Requiring mutual fund shareholder approval is unlikely to have any real effect on the decisions made by the fund.
- 5.19. In addition, it is possible for funds to find ways around the restrictions, as they have in the U.S. with respect to the 12b-1 fees. The SEC has recently made payments by advisers and funds to distributors and intermediaries an examination priority, which will include payments for distribution in guise and conflicts of interest related to compensation arrangements.<sup>53</sup> According to recent media report, SEC regulators are concerned that the payments could be used to give certain mutual funds preferential treatment and raise costs for investors.<sup>54</sup>

#### **CSA Proposal #4: A Separate Series or Class of Funds for Each Purchase Option**

- 5.20. The CSA proposes that each purchase option for a mutual fund (front-end sales charge, deferred sales charge (“DSC”), low-load, no load) could have its own series or class of securities so as to eliminate any cross-subsidization of commission costs by various investors within a mutual fund. Each series or class of mutual fund would bear its own distribution costs. DSC and low-load series or classes would be expected to have the highest management fees as those classes should incur the costs of financing the sales commissions the mutual fund manufacturer pays to advisors at the time of the investor’s purchase. This proposed change would allow or provide for the automatic conversion of mutual fund securities held in a DSC series or class to the lower-cost front-end load class at the end of the redemption schedule so as to benefit from the reduced management fee.

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<sup>53</sup> SEC National Exam Program, Office of Compliance Inspections and Examinations, Examination Priorities for 2013, (February 21, 2013), available online: <<http://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2013.pdf>>. Payments for distribution in guise include a wide variety of payments made by advisers and funds to distributors and intermediaries including revenue sharing, sub-TA, shareholder servicing, and conference support. Conflicts of interest related to compensation arrangements will involve SEC staff reviewing financial and other records to identify undisclosed compensation arrangements. Such activities may include undisclosed fee or solicitation arrangements, referral arrangements (particularly to affiliated entities), and receipt of payment for services allegedly provided to third parties.

<sup>54</sup> Mark Schoeff Jr., Investment News, “SEC to examine mutual fund distribution fees starting next week” (March 8, 2013), online: <<http://www.investmentnews.com/article/20130308/FREE/130309931>>.



- 5.21. **FAIR Canada does not support this proposed reform as it would simply add to the complexity in the number of versions of funds that exist in the marketplace while not addressing the root of the problem at issue for investors.** While it may suggest that the costs of the management fee would be more “fair” given the purchase option chosen, the fact remains that consumers are often unaware of what purchase option they have purchased under (because they do not actively choose the option), are not aware they have been placed in a DSC fund, or are unaware that trailing commissions are an ongoing charge that continues for as long as the fund is held, reducing the return while no or little service or advice is received in exchange.
- 5.22. FAIR Canada sees a greater advantage, as an interim step, in requiring all funds to have a class or series without a trailing commission. This would allow the investor to purchase and hold the fund while paying an upfront commission for any transaction or advisory fees or purchasing it without advice direct from the fund manufacturer or through a discount brokerage.

#### **CSA Proposal #5: Cap Commissions**

- 5.23. The CSA proposes that “[t]here could be a maximum limit set on the portion of mutual fund assets that could be used to pay trailing commissions to advisors as a way to mitigate the perceived conflicts of interest and the lack of alignment of advisor compensation and services.... This could be achieved by imposing a cap on the separate asset-based fee discussed as in CSA Proposal #3, noted above. Trailing commissions could further be plainly labelled or described as “ongoing sales commissions” in mutual fund disclosure documents, thus providing greater transparency for investors of their main purpose.”<sup>55</sup>
- 5.24. The CSA continues: “In addition, or as an alternative to a cap on trailing commissions at the mutual fund level, there could be a cap imposed on the aggregate sales charge, that is, the sum of any initial sales charge and “ongoing sales commission” that could be paid by an individual investor at the account level over the length of a mutual fund investment. Once the cap is reached, the investor’s holdings could be automatically converted to a series or class of securities of the mutual fund not bearing an ongoing asset-based sales charge. This would bring certainty to an investor as to the maximum sales commission payable. The U.S. imposes caps on commissions paid by mutual fund investors”.<sup>56</sup>
- 5.25. **FAIR Canada does not support this proposed change as, among other reasons, we believe that capping the amount of the trailing commission/ongoing sales commission, as is done with 12b-1 fees in the U.S,<sup>57</sup> will result in the cap becoming the new**

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<sup>55</sup> Consultation Paper at page 11270.

<sup>56</sup> Consultation Paper at page 11270. See footnote 137 which states that the front-end and deferred sales charges must not exceed 6.25% . There is a limit on trailing commission rates for both load and no-load investment companies. A 1% per annum cap is prescribed unless the fund is described as “no-load” or “no sales charge”, in which case the trailing commission cannot exceed 0.25% per annum,(at footnote 153 and 154 of the Consultation Paper).

<sup>57</sup> The Consultation Paper notes that the cap on the 12b-1 fee that may be charged on load classes is 1% (0.75% on distribution reimbursement fees and a cap of 0.25% on service fees) and no-load classes is limited to 0.25%, at page 11270.



**“minimum” that most or all funds will all charge investors.** There will be little incentive to charge less than the maximum, and much incentive for financial institutions and independent funds to charge the same embedded fee, knowing all too well that consumers do not pay much attention to fees and are often unaware of the existence of the fee in the first place.

- 5.26. Capping commissions would also not address the lack of transparency of these fees, would not deal with the fact that there may not be any services (including personalized advice) actually provided to the consumer in exchange for its payment (and how its purported purpose is a fluid concept), nor would it address the conflicts of interest issues.
- 5.27. Whilst it may look attractive to have an overall cap which, once reached, would require that an investor be put in a no-trailer-commission version of the fund, such a rule is subject to manipulation by dealers and their sales representatives. Clients could be advised to sell such funds in favour of a different fund once the consumer is nearing the cap in order to reactivate the trailing commission (although we would expect this to breach suitability requirements if done for purposes of obtaining the commission), and the consumer would be required to start paying the trailing commission associated with the new fund until that cap is reached. It would be much preferable for clients to pay directly for advisory services and to remove embedded commissions from mutual funds (and other investment products).
- 5.28. Whilst this proposed reform may have the salutary effect of limiting the marketing of certain funds that charge exorbitant trailing commissions in order to incent the sale of inferior product, it would not address the root problems we have identified with respect to mutual fund fees. **Simplifying the fee structure is preferable to adding to its complexity. One of the goals FAIR Canada suggests that the CSA consider is the simplification of the commission/fee structure so that consumers can more readily comprehend the fees that they will pay when they make investment decisions.** Do no-load funds end up having higher commissions than load funds? We question whether it is possible for the retail investor to determine this or other possible permutations at the time of his or her purchase, even if they were aware of the costs and knew of their importance.
- 5.29. Furthermore, we are generally of the view that regulators should not be in the business of setting prices for products. Instead their role should be to ensure the regulatory regime promotes price competition.
- 5.30. The OSC provided its preliminary view on the idea of capping trailing commissions in the Fair Dealing Model:

Our preliminary view is that imposing compensation ceilings on third party payments has a number of key disadvantages compared to eliminating the payment of compensation by third parties entirely. First, it leaves in place much of the complexity of current compensation schemes. Second, it ultimately

results in a more prescriptive regulatory regime. Third, the market in advice remains restricted and distorted.<sup>58</sup>

FAIR Canada agrees with OSC's preliminary view and believes that banning embedded commissions will achieve better protection for consumers of mutual funds.

### **CSA Proposal #6: Implement a Best Interest Statutory Duty**

- 5.31. The CSA proposes that “[t]o assist in mitigating the actual or perceived conflicts of interest that exist in the embedded advisor compensation system and that can result in a misalignment of advisors’ interests with those of investors, the CSA could impose a duty on advisors requiring them to put their clients’ best interests first, among other things.”<sup>59</sup>
- 5.32. FAIR Canada strongly believes that dealers and advisers should be required to act in their client’s best interest and that a statutory best interest duty must be introduced in order to protect investors. We believe that a statutory best interest standard is highly desirable and feasible and have provided our comments to the CSA in our submission dated February 22, 2013.<sup>60</sup>
- 5.33. FAIR Canada sees a number of important benefits which would result if a statutory best interest standard was introduced, including:
- Increased protection for consumers;
  - Better financial outcomes for consumers
  - More effective competition;
  - An increase in the level of professionalism in the financial services industry; and
  - An increase in the level of trust in the financial services market.
- 5.34. A best interest duty would require regulators to consider whether embedded commissions are compatible with the best interest duty. FAIR Canada has great difficulty in understanding how an adviser or dealer (or their representative) required to act in the client’s best interest could accept payments from a third party and fulfill their duty to the client. We believe that a best interest standard should include a prohibition against the acceptance of embedded commissions. In order to be independent, advisors should be paid by the consumers they serve.
- 5.35. A best interest duty would improve outcomes for consumers because it would explicitly require registrants to consider the investment’s costs in determining whether the investment is in the best interest of the consumer.

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<sup>58</sup> Ontario Securities Commission, “The Fair Dealing Model” (Concept Paper) (January 2004), online: <[http://www.osc.gov.on.ca/documents/en/Securities-Category3/cp\\_33-901\\_20040129\\_fdm.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category3/cp_33-901_20040129_fdm.pdf)> at Appendix F at page 9.

<sup>59</sup> Consultation Paper at page 11271.

<sup>60</sup> *Supra* note 19.

- 5.36. A best interest duty will enhance the professionalism of the financial services industry and enhance public trust in the industry. Further, it would assist the financial advice industry in its ambition to be recognized as a profession.
- 5.37. A best interest duty will reduce investors' agency costs, which arise as a result of conflicts of interest, and which negatively impact a consumer's long-term savings.<sup>61</sup> In particular, financial consumers will no longer need to analyze recommendations from financial advisors to factor in the effect of conflicts of interest, which research has demonstrated they are ill-equipped to do.
- 5.38. A best interest duty, which addresses issues relating to conflicted remuneration, including embedded commissions, will reduce bias in recommendations, thus making recommendations more objective. As discussed above in section 3, it will also eliminate much of the need for conflicts disclosure, which has been demonstrated not to work and to cause unintended negative consequences for investors.
- 5.39. A best interest duty will facilitate more informed consumer choice about the purchase of advice. We expect that, if embedded commissions were prohibited, investors would be encouraged to look more critically at what they are getting for what they pay. This would improve competition and economic forces would spur innovation in the delivery of cost-effective advice that meets a best interest standard. While some evidence suggests that investors indicate a preference for paying through embedded commissions<sup>62</sup>, FAIR Canada believes that public policy should provide for informed consumer choice and healthy competition.
- 5.40. **FAIR Canada commends the CSA for moving forward with initiatives such as the Fund Facts document and the cost disclosure and performance reporting requirements.** These initiatives have been opposed by many in the industry, including industry lobby groups such as the Investment Funds Institute of Canada ("IFIC"), and as a result, have taken a considerable amount of time to come to fruition. Such opponents are now resigned to publicly supporting the benefits of such initiatives and point to them as a reason not to proceed with other much-needed initiatives.
- 5.41. Notwithstanding the opposition, these initiatives, once implemented, will go a long way to providing better information to consumers about the cost of their investments. However, FAIR Canada does not believe these initiatives, on their own, can ameliorate the problems that the CSA has identified or that FAIR Canada has described. While we believe that full information should absolutely be provided to consumers, we urge regulators to move on to Stage 3 of the Point of Sale initiative so that consumers receive a copy of the Fund Facts document before they make their investment decision as was originally intended a decade ago. While these reforms are salutary, they do not adequately address conflicts of interest or the full trust and reliance consumers place in and on their advisors.

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<sup>61</sup> *Supra* note 19, at paragraphs 2.24 to 2.29.

<sup>62</sup> See, for example, Pollara Inc., "Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry" (2011) (prepared for the Investment Funds Institute of Canada), online: <<https://www.ific.ca/Content/Document.aspx?id=6842>>. FAIR Canada questions some of the conclusions drawn from this research.

- 5.42. A best interest duty will improve outcomes for consumers because it will ensure the most efficient allocation of responsibilities between the advisor and the consumer given the level of financial literacy of consumers, the degree of knowledge and specialized skills and abilities that the advisor needs to possess, and the complexity of financial products. As noted by the CSA, most consumers assume advisors already have a legal duty to act in their best interests and when this is combined with a large degree of informational asymmetry and low financial literacy, the complexity of the commission and fee structure and the opaqueness costs of investing, it is clear that it would be beneficial for consumers and advisors to raise the standard to one of best interests of the client.

***FAIR CANADA RECOMMENDATION: We recommend that the CSA implement a best interest duty for advisers and dealers.***

### **CSA Proposal #7: Ban Embedded Commissions**

- 5.43. In the Consultation Paper, the CSA states:

In order to address the actual or perceived conflicts of interest that embedded advisor compensation gives rise to, and at the same time improve the transparency, negotiability and fairness of ongoing advisor service costs for investors, measures could be adopted, similar to those being implemented in the U.K. and Australia, under which the payment to advisors of sales and trailing commissions set by mutual fund manufacturers would no longer be permitted. Advisor compensation would no longer be embedded in the management fees charged on mutual funds. Instead, advisors would need to discuss with their client how they will be paid for the sale and ongoing servicing of mutual fund investments and obtain the client's agreement to the proposed fee-for-service model."<sup>63</sup>

***FAIR CANADA RECOMMENDATION: We recommend that advisory service fees (i.e. paying for advice) and any commissions should be paid directly by the investor as it is for individual stocks.***

- 5.44. Investors will be better protected if there is greater cost transparency. If there needs to be an ongoing fee for monitoring the portfolio of mutual funds and other investment holdings of the consumer, a fee for doing so must be discussed with the consumer prior to it being charged, and must be paid directly by the consumer.
- 5.45. Any costs associated with a consumer's account should be accurately described and fully transparent and the name of the cost should reflect its purpose: fee for advice; fee for administrative services; sales commission; etcetera.

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<sup>63</sup> Consultation Paper at page 11271.

- 5.46. FAIR Canada supports the disclosure of costs in dollar amounts rather than in percentages given that consumers who see costs in percentage terms or fractions of a percent are less able to understand the costs they are paying.<sup>64</sup>
- 5.47. FAIR Canada sees the ban on conflicted remuneration and, in particular, the banning of third party commissions as the best way to protect consumers from conflicts of interest which have been described above and which lead to recommendations that are not in the best interest of consumers. FAIR Canada agrees with the CSA that removing embedded commissions would address the conflicts of interest that such commissions give rise to, and would improve the transparency, negotiability and fairness of ongoing advisor service costs for investors.<sup>65</sup> FAIR Canada also agrees with the CSA that removing embedded commissions would allow the consumer to more easily compare the costs of advice and the operating costs of mutual funds since the MER of the mutual fund would represent the operational costs of the fund and would not include the advisor compensation costs.<sup>66</sup>
- 5.48. **Third party commissions need to be removed since they inhibit healthy competition, in that they encourage anti-competitive behaviour between issuers or their agents to pay higher commissions to a sales force in order to sell more of their product. Instead of competing on the basis of lowest costs or best value to consumers, they compete to win the business of advisors, thus driving up the costs of investing to unsophisticated consumers.**
- 5.49. The Consultation Paper provides useful information on the evolution of mutual fund fees in Canada. The trends noted in the Consultation Paper do not demonstrate that investors are being adequately protected by the existing framework.
- 5.50. The Consultation Paper reveals that the trailing commission has become an increasing source of revenue for advisors, growing from about one quarter of the advisor's book of business in 1996 to 64% in 2011. From the investor perspective, this means that the majority of retail investors are less aware of the costs they are paying. It is no wonder that many consumers mistakenly believe there is no cost to purchasing or owning a mutual fund.<sup>67</sup>

### **Mutual Funds Are Sold, Not Bought**

- 5.51. The Consultation Paper also makes it clear that fund of fund products are being heavily promoted to consumers, with the majority of consumers' money going into fund of fund products. For example, in 2011, \$19.5 billion went into fund of fund products and \$6.5 billion went into long-term stand-alone funds. IFIC's Industry Overview for February 2013 reports that \$5.42 billion of fund of fund mutual funds were sold in February

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<sup>64</sup> Dr. Edwin L. Weinstein, "Report : Performance Reporting and Cost Disclosure" (September 17, 2010) (prepared for: Canadian Securities Administrators); and (2012) 35 OSCB 5429 (CSA Cost Disclosure, Performance Reporting and Client Statements) at page 5431.

<sup>65</sup> Consultation Paper at page 11271.

<sup>66</sup> Consultation Paper at page 11271.

<sup>67</sup> Consultation Paper at page 11252.

compared to \$2.22 billion of stand-alone funds. **Their growing “popularity” no doubt is a result of the significantly higher trailing commission paid on fund-of-fund products. The average asset-weighted MER of fund-of-fund products is also well above that paid on similarly invested stand alone funds.** Such funds pay higher trailing commissions despite the fact that the advisor has less work to do since fund selection and asset allocation are pre-packaged and the advisor needs only to assess suitability of the top fund rather than every fund in the portfolio. In addition, fund-of-fund mutual funds fuel the growth of proprietary funds, which tend to be the underlying investments, thereby increasing the manufacturer’s overall assets under management, which in turn increases total management fees payable to the manufacturer. While the mutual fund manufacturer and the advisor appear to be benefiting from the growth of fund-of-fund products, we see these trends as contrary to the consumer’s interests, primarily because they are being placed in the highest fee products.

- 5.52. Given that most academic studies have found that the best predictor of a fund’s return is its expense ratio, (i.e. funds with higher fees tend to underperform their competitors<sup>68</sup>), and given the relatively low interest rate return environment that is likely to persist, we fail to see how the advisers and dealers can claim to be acting in the client’s best interests when profiting from third party payments which create compensation incentives to place consumers in the highest fee type mutual funds category (funds-of-funds) with the average MER being 2.7%.<sup>69</sup>
- 5.53. **FAIR Canada believes that the proposal to ban embedded commissions is the best method to address the issues and concerns identified by the CSA in the Consultation Paper. A best interest standard, with its accompanying ban on embedded commissions, would be principle-based and would prevent sales practices and behaviours that may be all too common today, but that are contrary to the protection of consumers and fail to place the interests of consumers ahead of the interests of the manufacturer and intermediaries who distribute their products. Removing this “choice” of conflicted business model will not harm investors and to suggest it will is nonsensical.**
- 5.54. Given that a best interest standard is a principled approach to delivering services to consumers, it would be less apt to be circumvented than would a rules based approach to regulation (such as capping fees, and the other alternatives discussed above). The experience in the U.S. and elsewhere shows how it is possible to get around the restrictions imposed by rules through other forms of compensation, which defeats the purpose of the rule in the first place and makes the understanding of fees difficult, if not impossible to explain, let alone understand.
- 5.55. Removing embedded commissions would allow consumers to assess whether they receive value for the costs they pay for advice. This will improve competition and

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<sup>68</sup> *Supra* note 20 (Wilkinson-Ryan and Fisch).

<sup>69</sup> See footnote 66 of Consultation Paper at page 11251.

economic forces would spur innovation in the delivery of cost-effective advice that should be required to meet a best interest standard.

### Smaller Accounts

- 5.56. Some industry participants argue that the current system allows the mutual fund industry to service clients with smaller accounts by allowing those accounts to be subsidized by the higher profits earned from clients with larger accounts. The argument is that if you take away embedded commissions there will be an “advice gap” where those consumers who have smaller amounts to invest will not be able to afford advice. FAIR Canada disagrees with this analysis.
- 5.57. It is our understanding that the fee-based compensation system that charges fees based on the amount of client assets under management, as presently structured, generally imposes higher percentage fees for those with lower levels of assets, and is not always available to those who have less than a minimum asset threshold. It is also argued by some that this type of account is not suited to the buy and hold investor. While this may be true, FAIR Canada is confident that the market will adjust to the best interest regulatory standard and elimination of embedded commissions and that new business models, including different fee-based compensation systems or other alternative business models, will emerge to serve the various segments of the market, including the lower asset segment.
- 5.58. As suggested in the Fair Dealing Model, the subsidization of smaller accounts by larger ones could also be addressed through firms creating a fee schedule that entails some subsidization of smaller accounts.<sup>70</sup> This should be possible, especially if, as IFIC has stated, most investors begin to work with an advisor when they have a modest amount of savings.<sup>71</sup> By taking a long term view of the relationship, and a long term business plan approach, smaller investors can continue to be served profitably under a fee-based model. Firms will benefit over time as such clients grow their assets.
- 5.59. FAIR Canada believes that if effective competition is promoted by banning embedded commissions, new choices will emerge for investors and that advice will be available, likely at a lower cost than is presently unwittingly paid. Innovation and competition will drive down consumer costs. This will improve financial outcomes for consumers.

### Regulatory Arbitrage

- 5.60. While some members of the investment industry also resists the banning of embedded commissions by arguing that advisors who are licensed to sell other higher fee products will do so, thereby engaging in regulatory arbitrage, FAIR Canada has made a number of recommendations to address this concern, including:

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<sup>70</sup> *Supra* note 58, at Appendix F at page 7.

<sup>71</sup> The Investment Funds Institute of Canada, “The Value of Advice: Report” (November 2011) at page 3. FAIR Canada does not agree with the conclusions drawn from the data provided.



- *Advice Not to Invest in a Security is Advice* - statutory best interest duty should apply to a recommendation by a securities registrant to purchase a segregated fund, principal protected note or other investment product regardless of whether it falls under the provincial securities legislation's definition of "security". The recommendation to invest in comparable products necessarily constitutes advice about securities (that is, it is advice to not invest in a security) and should therefore be subject a best interest standard. Failure to apply the standard to a securities registrant selling non-securities products may create incentives to sell such products to avoid consumer protection measures;
- *Amend "Securities" Definition* - To provide consumers of segregated funds and other investment products with the same level of investor protection as mutual funds, the carve-out in the provincial securities acts, which provide segregated funds with an exemption from securities legislation, should be removed. Segregated funds (Insurance Variable Investment Contracts) are securities and should not be exempted from provincial securities acts (They have been exempted from securities regulation purely as a result of political lobbying by the insurance industry. There is simply no justification for lower standards of regulation or business conduct in the sale of segregated funds.); and

*Preclude Acceptance of 3<sup>rd</sup> Party Commissions* - To apply a consistent level of investor protection, FAIR Canada recommends that all securities registrants should be prohibited from *accepting* any third party embedded commissions in respect of financial products that are not regulated under provincial securities legislation that they also may be licensed or otherwise permitted to sell, in order to meet their statutory best interest duty (in order to comply with the duty of loyalty). This will encourage the advisor to recommend the best financial product rather than the one that earns them the most commission, across the board, regardless of how the product is regulated.<sup>72</sup>

- 5.61. The fact that most members of the CSA do not have the jurisdiction to regulate all financial products nor the persons who provide those financial products to consumers does not lessen the importance of banning embedded commissions for securities registrants. Regulation should not be a race to the bottom but rather aim to create a new higher standard of conduct which other pillars of the financial services sector will wish to adopt or will be pressured to adopt in other forums. Securities regulators have to start somewhere to address the concerns that have been identified.

### Leveraged Investing

- 5.62. FAIR Canada recommends that the CSA immediately address the risks of providing unsuitable recommendations to borrow to invest by precluding advisers and dealers from charging asset-based fees on monies that are borrowed for investment purposes and prohibiting the payment of a trailing commission in respect of amounts invested

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<sup>72</sup> *Supra* note 19 at section 9.

using borrowed funds. This reform has been adopted by the Australian Securities and Investments Commission.<sup>73</sup>

### Return of Capital Funds

- 5.63. FAIR Canada recommends that the CSA take immediate steps to address the risks of providing unsuitable recommendations to borrow to invest in return of capital funds by precluding advisors from recommending that clients borrow to invest in such funds.

### Do Not Delay Reforms

- 5.64. Instituting a statutory best interest duty, and its associated ban of embedded commissions, will address many conflicts of interest and misaligned incentives which are inherent in the structure of mutual fund fees. FAIR Canada sees no justification for waiting until the Point of Sale initiative and CRM2 requirements come into effect before taking steps to address the concerns that have been identified and described by the CSA in the Consultation Paper.
- 5.65. The current mutual fund fee structure contains serious conflicts of interest which are not addressed by the Point of Sale initiative or CRM2. These conflicts result in inadequate consumer protection and inadequate consumer information. Given the concerns identified by the CSA, and in order to fulfill CSA Members' mandates to foster fair and efficient capital markets and protect investors from unfair, improper or fraudulent practices, there is no justifiable reason to wait and "...monitor and assess the effects of related regulatory reforms in Canada and around the world"<sup>74</sup> before considering the reform options proposed in the Consultation Paper. We see no reason to wait until CRM2 comes into effect three years from now, and then to wait beyond that to see its effect, when neither Point of Sale nor CRM2 meaningfully address the serious conflicts of interest that have been identified by the CSA in the Consultation Paper and that we discuss in this submission.
- 5.66. Moreover, we do not see the necessity for waiting several years until the practical effects or regulatory reforms (i.e. banning embedded commissions) on financial industry participants in the U.K. and Australia are "fully understood and thoughtfully considered" before considering the proposed reforms set out in the Consultation Paper and discussion in this submission. Securities regulators do not have as their mandate the protection of business models or the support of a particular level of profitability of the financial industry, especially business models which do not serve consumers and lead to poor outcomes.
- 5.67. Given the vast number of Canadians who own mutual funds for the purpose of saving adequately for their retirement, further delay will impose real costs on over 12 million

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<sup>73</sup> Australian Securities and Investments Commission, "Response to submissions on CP 189 Future of Financial Advice: Conflicted remuneration" (March 2013), online: <[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep328-published-4-March-2013-B.pdf/\\$file/rep328-published-4-March-2013-B.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep328-published-4-March-2013-B.pdf/$file/rep328-published-4-March-2013-B.pdf)>, at page 5.

<sup>74</sup> (2012) 35 OSCB 11233 at 11234.

Canadians. Securities regulations should heed the practical effects of inaction for Canadians.

- 5.68. Industry lobby organizations opposed to regulatory reform invariably propose that regulators undertake more studies (including cost-benefit analyses) as a tactic to derail and delay investor protection reforms. This tactic is currently being used in the U.S. to prevent the introduction of uniform fiduciary duty standard by the SEC. Industry stakeholders do not call for similar studies when reforms they support (such as equity crowdfunding) are proposed. Securities regulators should see through these delaying tactics.

## 6. CONCLUSIONS

- 6.1. **FAIR Canada urges the CSA to implement reforms quickly in light of the serious conflicts of interest which exist in the existing mutual fund fee structure and to not delay in favour of “monitoring” and “assessing” developments elsewhere or while the long-delayed Point of Sale and CRM2 initiatives continue to be implemented here.**
- 6.2. **While those initiatives are important to consumers, disclosure will not be enough to ensure adequate investor protection nor will they facilitate a competitive and efficient mutual fund market in Canada. We recommend that the CSA move forward to ban embedded commissions.**

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-214-3443 (ermanno.pascutto@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,



Canadian Foundation for Advancement of Investor Rights