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Dear Sirs / Mesdames,

**CSA DISCUSSION PAPER AND REQUEST FOR COMMENT 81-407
MUTUAL FUND FEES**

We are writing in response to the Canadian Securities Administrators' (CSA's) Discussion Paper and Request for Comment 81-407 Mutual Fund Fees (the "Discussion Paper").

A. About Advocis

Advocis, The Financial Advisors Association of Canada, is the country's largest and oldest professional membership association of financial advisors and planners in Canada. Through its predecessor associations, Advocis proudly continues over a century of uninterrupted history of serving Canadian financial advisors and their clients.

Our over 11,000 members are licensed to sell life and health insurance, mutual funds and other securities, and are primarily owners and operators of their own small businesses who create thousands of jobs across Canada.

As a voluntary organization, Advocis is committed to professionalism among financial advisors. Advocis members adhere to our published Code of Professional Conduct, uphold standards of best practice, participate in ongoing continuing education programs, maintain professional liability insurance, and put their clients' interests first. Across Canada, no organization's members spend more time working one-on-one with individual Canadians on financial matters than do ours. Advocis advisors are committed to educating clients about financial issues that are directly relevant to them, their families and their future.

B. Executive Summary

Mutual fund investing and embedded compensation offer Canadian consumers tremendous benefits: professional investment management, financial and tax planning, managed risk, efficiencies of scale in trading of underlying assets, accommodation of small retail accounts, income tax reporting slips and low-cost. While the benefits that accrue to mutual fund investors are also available to those who use fee-based accounts, embedded compensation makes the benefits of mutual fund investing available to consumers who have small amounts to invest, who would likely not be willing or able to establish fee-based accounts and pay separately for advice.

Embedded compensation pays mutual fund dealers and advisors for ongoing client service. Both dealers and advisors bear ongoing fixed costs that are covered out of this embedded income stream, regardless of whether or not the client requests further services or advice. These costs include suitability reviews, internal compliance infrastructure, advisors' licensing fees, E&O, SRO fees and technology infrastructure.

Mutual fund investing, facilitated by embedded compensation, makes the benefits of financial advice much more accessible to low-income consumers than would be the case through fee-based accounts. Eliminating embedded mutual fund compensation will limit consumer access to financial advice, particularly at the lower end of the wealth and income spectrum.

Embedded compensation supports mutually beneficial advisory relationships between financial advisors and the millions of consumers they serve. There is strong evidence that Canadian consumers at all wealth and income levels benefit significantly from access to financial advisors, and are able to accumulate much greater savings than those who do not use financial advisors.¹

Recent experience in the UK, where embedded compensation has been replaced by an "adviser charging" regime, indicates that without embedded compensation, it is likely that many consumers who are accustomed to investing in mutual funds with embedded

¹ See Section C, The Value of Financial Advice, below.

compensation will not be willing to pay large separate fees for advice, and will not save and invest for retirement as they otherwise would.²

C. The Value of Financial Advice

Embedded compensation in the form of trailing commissions on mutual funds makes it possible for thousands of financial advisors to provide financial advice to millions of Canadians. Many of these consumers access the advice of financial advisors precisely because embedded compensation makes investing small amounts in mutual funds much more accessible than the alternative of investing through a fee-based investment account and paying separately for advice.

Academic studies have confirmed that Canadians benefit tremendously from access to financial advice, and Canadians who use financial advisors consistently accumulate more wealth, at all wealth and income levels, than those who do not use financial advisors.

In July 2012, Professor Claude Montmarquette and Nathalie Viennot-Briot of the Montreal-based Centre for Interuniversity Research and Analysis on Organizations ("CIRANO") released Canada's largest and most scientific independent study to date on the value of advice. The study, entitled *Econometric Models on the Value of Advice of a Financial Advisor* (the "CIRANO Study"), is based on data collected from over 10,000 households in 2010 and 2011 and provides strong evidence of the connection between financial advice and the accumulation of financial wealth.

After accounting for more than 50 other variables that could also influence wealth accumulation, the CIRANO Study reported the following:

1. People who work with a financial advisor and receive financial advice accumulate considerably more wealth over time than people who do not receive financial advice. Notably, the researchers found that the longer the relationship with the advisor, the greater the beneficial impact for consumers: households with four-to-six year long relationships accumulated 58% greater assets than non-advised households, whereas households with 15+ year relationships accumulated 173% greater assets.
2. Advice is not exclusively for the wealthy. Despite consumers' general misconceptions, financial advice is not only beneficial for high net worth ("HNW") clients. In the CIRANO Study, the median initial investment for advised households was only \$11,000, demonstrating that financial advice is beneficial to the lower- and mid-net worth segment of the market, and that advisors are serving this segment under the current regulatory regime.

² See Section D, vii (b) "Canadian regulators should wait to see the impact of reforms in the UK"

3. The advice that financial advisors provide helps consumers to save and prepare for retirement. The researchers found evidence that points to improved savings behaviour being the key to the success of advised households in accumulating assets relative to their non-advised peers, and the important role of the financial advisor in encouraging this behaviour. There was a significant gap between advised and non-advised households in their reported feelings of confidence regarding their preparedness for retirement.
4. Advice increases trust, satisfaction and confidence in financial advisors. The CIRANO Study found that advised households reported a higher degree of trust and confidence in financial advisors, relative to non-advised households. This demonstrates that even if consumers are initially apprehensive about the value of advice and question what financial advisors can offer, actually working with an advisor and seeing the results first hand confirms, from the consumer's perspective, the value of the advisor.³

The CIRANO Study confirms previous research conducted by the Investment Funds Institute of Canada ("IFIC"). In each of 2010 and 2011, IFIC released studies (the "IFIC Studies") that indicate a likely correlation between financial advice and higher levels of financial assets, retirement readiness and financial literacy among consumers.⁴

The IFIC Studies reported that advisors: promote values that benefit clients throughout their investing lifetimes (such as the early adoption of a savings and investment mindset); help clients build wealth through tax-efficient plans based on asset mixes that are sensitive to clients' particular circumstances and risk tolerances; and contribute to the financial literacy of Canadians by taking the time to explain important concepts. The 2011 IFIC Study concluded that these and other factors "provide net return advantages that exceed the additional cost for advice that is contained within the mutual funds or other financial products used by the investor."

The IFIC and CIRANO Studies confirm that financial advice provides tremendous value to Canadians. This value is manifested not only in quantitative terms, such as the substantially greater accumulated wealth enjoyed by advised households, but also in the peace-of-mind and confidence in knowing that one is prepared to deal, at least financially, with life's most significant events. The fact that working with a financial advisor increases trust and satisfaction in financial advice demonstrates that non-advised Canadians may undervalue what financial advisors can offer, leading to sub-optimal outcomes. While it is up to the industry to solve this informational inefficiency,

³ For more details about the CIRANO Study, including the methodology used, we encourage the CSA to review the document in its entirety, which is available at www.cirano.qc.ca/pdf/publication/2012RP-17.pdf.

⁴ The 2010 and 2011 IFIC Studies are available at <https://www.ific.ca/Content/Document.aspx?id=5906&LangType=1033> and <https://www.ific.ca/Content/Document.aspx?id=6921&LangType=1033>, respectively.

regulators should be careful not to exacerbate the issue by enacting policies that would act as a further barrier to Canadians' ability to access advice.

D. Topics for consideration

Set out below are our comments regarding some of the potential changes that are outlined briefly under the heading “topics for consideration.” (For convenience, our comments are listed in accordance with the numbering in the Discussion Paper; however we have no comments concerning item iv.)

i. Advisor services to be specified and provided in exchange for trailing commissions

Trailing commissions compensate dealers and advisors for ongoing client service, and help to defray many of the costs of providing such services. Both dealers and advisors bear ongoing fixed costs that must be defrayed by client compensation, regardless of whether the client requests further services or advice. These costs include suitability reviews, internal compliance infrastructure, advisors' licensing fees, E&O, fees to the MFDA and technology infrastructure.

We believe it would be an error to treat trailing commissions as compensation that is specifically provided in exchange for specified ongoing future services.

A provision to reverse trailing commissions based on complaints about post-sale service would impose additional administrative burdens on dealers, advisors and fund companies. There are likely to be added costs for software changes, recordkeeping, audit procedures, and administration relating to the documentation of post-sale service. Such provisions also could invite complaints from investors who are unhappy with their returns and could encourage litigation that would turn on whether dealers and advisors are able to establish that they provided sufficient post-sale service.

ii. A standard class for DIY investors with no or reduced trailing commission

Requiring every mutual fund to have a low-cost ‘execution-only’ series or class of securities available for direct purchase by investors would be likely to prompt many consumers to engage in Do it Yourself (“DIY”) mutual fund investing without the benefit of professional financial advice.

While there are many investment products that can be purchased without advice, we believe policymakers and regulators should consider whether it is desirable, as a matter of policy, to expand the distribution of mutual fund securities without advice by requiring every mutual fund to offer a low-cost execution-only alternative.

DIY investing is not appropriate for most consumers. People need knowledge, motivation and time, at the very least, in order to be successful at DIY investing. Consumers benefit greatly from the fact that the financial advisors they work with are

required to ensure that the financial products they invest in are suitable to their needs and risk profile. Increasing availability of low-cost mutual fund investments would be attractive to many consumers who are not equipped to be successful DIY investors.

Given what is known about the tremendous value that consumers derive from financial advice and from working with a financial advisor on an ongoing basis, we believe it would be a mistake to require all mutual funds to make a low-cost 'execution-only' series or class of securities available for direct purchase by investors. We would go further, and suggest that, given the value of advice, regulators and policymakers should be looking for ways to encourage consumers to access professional financial advice.

iii. Trailing commission component of management fees to be unbundled and charged/disclosed as a separate asset-based fee

Unbundling the commission component of management fees inform consumers more clearly, how much of the mutual fund fees that they pay are going to the dealer and advisor.. The increased transparency would help consumers to understand how much they are paying for trailing commissions and how much for management fees, and to compare these costs as between funds. It also should make it easier to compare MERs of Canadian mutual funds and the MERs of US funds.

Unbundling would likely have a competitive impact on fee levels and other competition-related consequences. Presumably, some consumers will compare funds based on the unbundled "embedded compensation" fee, and some funds may appear more attractive based on lower MERs after the trailer is separated out.

v. Cap commissions

We do not believe that the actual amount of trailing commissions is a matter of particular concern that would warrant imposing a cap on total compensation. Trailing commissions typically are not large in percentage terms. The main concerns that have been expressed about trailing commissions involve perceived conflicts of interests and the lack of alignment of advisor compensation and services. It is not clear to us that capping the compensation would make a difference that would actually benefit clients.

vi. Implement additional standards or duties for advisors

In February, 2013, Advocis has addressed these issues in a response to the Canadian Securities Administrators' ("CSA") Consultation Paper 33-403 (the "Consultation Paper") entitled The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice Is Provided to Retail Clients.⁵

⁵ <http://www.advocis.ca/regulatory-affairs/RA-submissions/2013/Advocis-Response-to-CSA-Consultation-Paper.pdf>

In the letter, we expressed the following views regarding the proposed statutory fiduciary standard (at page 3):

“The statutory fiduciary standard considered in the Consultation Paper would further exacerbate the burden on advisors and provide little benefit to consumers. This is especially true in Canada, where we already enjoy a principles-based fiduciary standard that is well established in common law. This common law duty serves clients and advisors alike extremely well, as it allows for the consideration of the specific relationship at issue and other important factors in context. Canada's common law fiduciary duty represents the type of principles-based regulation that regulators should be striving for more broadly.

Supplanting Canada's common law fiduciary standard with one based in statute would: (i) fail to recognize important differences among "retail" clients; (ii) impose significant additional costs on financial advisors; (iii) put well-accepted business models into jeopardy; (iv) detract from principles-based regulation; and (v) cause a misalignment of standards in the financial services industry. Cumulatively, these problems would force many financial advisors out of the industry, harming the ability of lower- and middle-net worth Canadians to access financial advice and running counter to the CSA's stated objective of improving consumers' financial literacy. A statutory fiduciary duty would also fail to address the most serious consumer risks, including fraud or incompetence.”

We believe that if a statutory best interests duty is to be introduced as a result of recommendations that result from the “Statutory Best Interests” consultation process, the implications for long-standing, well-established compensation practices, such as the payment of trailing commissions, should be made very clear in the context of that process. If it is contemplated by the regulators that existing commission structures could be incompatible with a best interests duty, that should be made very clear before the best interests duty reaches the stage of a regulatory proposal.

vii. Discontinue the practice of advisor compensation being set by mutual fund manufacturers

a. Initial comments

Prohibiting third party compensation to distributors of mutual funds through embedded compensation will drive out advisors who serve middle-class and lower income individuals and families. Small business financial advisors that offer comprehensive financial advice and planning to those individual and families that need it most will leave the industry, leaving the field increasingly dominated by large integrated financial firms.

The benefits of replacing embedded compensation with adviser charging, and imposing a sweeping change of the compensation structure that applies to the mutual fund

industry remain to be seen. Early indications are that the reforms in the UK and Australia are resulting in reduced access to financial advice for average consumers.⁶

Few financial products are distributed without payment of compensation to the intermediary that is embedded in some way in the price of the product. If the claimed shortcomings of embedded compensation in the distribution of mutual funds justify the imposition of an adviser charging regime on mutual funds, perhaps in the interests of consistency the same approach should be taken with managed portfolios and other similar pooled investment arrangements, bonds, initial public offerings and other securities that involve embedded compensation. In the interests of consistent regulation, perhaps dealers should not be permitted to sell securities at a markup out of their own inventory, or receive incentives of any kind from third parties. For consistency, perhaps no financial intermediary should be permitted to provide sales incentives or bonuses of any kind to its employees and sales agents in respect of the distribution of any financial products or accounts to consumers (including credit cards and other debt products).

b. Canadian regulators should wait to see the impact of reforms in the UK

In the UK the consulting firm Deloitte LLP undertook a survey (the “Deloitte Report”) of more than 2000 adults to find out how consumers are likely to respond to the new Adviser Charging (AC) Regime that is being introduced as part of the Retail Distribution Review. The Deloitte Report was issued in November 2012.⁷

The Foreword to the Deloitte Report provides the following overview of the findings:

“The survey suggests adviser charging will transform purchasing behaviour as customers become more aware of adviser costs. Many customers are likely to opt out of advice completely, partially opt out, or seek much higher levels of service for the charges they will incur. A third of customers will respond to AC by doing their own planning, research and administration.

At the same time, Independent Financial Advisers (IFAs) and bank advisers are likely to de-prioritize a large proportion of their customers as they move up market to defend profit margins. This is based on their understanding that customers with lower levels of savings will be less willing or able to pay adviser charges.

Combined, these changes mean that there will be up to 5.5 million disenfranchised customers who will either choose to cease using financial advisers or lack access to them. These customers, who account for 11 per cent of UK adults, will represent a significant post-RDR advice gap.”

⁶ See footnotes 7 and 8.

⁷ The report, issued in November 2012, titled “Bridging the advice gap, Delivering investment products in a post-RDP world” (the “Deloitte Report”) is available online at <http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-bridging-the-advice-gap.pdf>.

The Deloitte Report indicates that adviser charging means that consumers will receive much less professional financial advice:

(p.7):

“Many customers will stop taking advice in response to AC. When asked what they would do if charged directly for an adviser's time, some 27 per cent said they would stop taking advice and 32 per cent said they would do their own planning, research and administration. ...

A significant proportion of customers are likely to opt out of advice on a selective basis. One quarter (24 per cent) of survey respondents suggested they would reduce the use of advisers, and only pay when they are most needed, i.e., when making the most important decisions. In addition, 10 per cent said that “if charged directly” they would use advisers only to execute product purchases, in order to minimize costs.”

The 2012 Blackrock Investor Horizons Survey of UK consumers⁸ is consistent with the Deloitte Report: only 35% of respondents were willing to pay a fee for financial advice,

“with the average cost per hour they are willing to pay being very low at £42 per hour. (C\$66 +/-)” Twenty-eight percent said they would be willing to pay £25 an hour (C\$39 +/-) for financial advice - making it the most popular amount - while 18% would just pay £10 (C\$15.60 +/-) an hour.”

A US study conducted for the credit union industry of consumer attitudes regarding financial advice found that the least-affluent and least-educated group of consumers in their study were unwilling to pay for financial advice.⁹

Research from Australia, where reforms that are similar to the UK adviser charging regime are being implemented, is consistent with the Deloitte and Black Rock studies, and shows that consumers generally are not willing to pay separately for financial advice, and that the amounts they say they would be willing to pay for advice are very small in relation to the cost of providing such advice.

A report issued by the Australian Securities and Investments Commission (ASIC) in December 2010 (the “ASIC Report”)¹⁰ examined how much consumers would be willing to pay for financial advice. The ASIC report notes (at page 25):

⁸ Online at <http://www.blackrock.co.uk/literature/brochure/blackrock-investor-horizons-survey.pdf>

⁹ “Professional Financial Advice for Consumers: Implications for Credit Unions”, Jinkook Lee, Ohio State University and William A. Kelly, Jr., University of Wisconsin – Madison, 2003. Online at http://filene.org/assets/pdf-reports/1752-92Professional_Advice.pdf

¹⁰ Report 224, “Access to financial advice in Australia”, online at [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep224.pdf/\\$file/rep224.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep224.pdf/$file/rep224.pdf)

“On average, consumers believe that initial advice should cost \$301 and ongoing advice should cost \$298 per annum. Twenty two percent of consumers believe that the initial advice consultation should be free.”

The ASIC report goes on to discuss the challenge that the financial industry would face, given the divergence between what consumers say they are willing to pay for advice and what it actually costs to provide the advice (at p.47):

“According to licensees, the cost of providing advice is on average \$2,500 to \$3,500 This is considerably more than the average \$301 that consumers are prepared to pay to receive advice as reported in the research ...

While a number of licensees are aware of the significant gap between what they charge for advice and what consumers are willing to pay for advice, our research found that licensees are having difficulty lowering the cost of advice. This is because there are a number of fixed costs associated with providing advice including:

- (a) employing and remunerating the financial planner providing the advice;
- (b) employing and remunerating any paraplanning function assisting in providing the advice;
- (c) compliance costs (including professional indemnity insurance);
- (d) technical support and ongoing training of the financial planner; and
- (e) monitoring and supervision costs of the financial planner by the licensee.

Another major expense cited by licensees is the cost associated around the production of often lengthy advice documents.”

The very real concern that the Deloitte Report, the Black Rock Investor Horizons Survey and the ASIC Report highlight, is that requiring consumers to pay separately for financial advice that has historically been embedded in the price of financial products is likely to result in a dramatic change in consumer behaviour. The pronounced reluctance of consumers to pay separately for advice shows that consumers clearly prefer the embedded compensation model, and eliminating that model and requiring consumers to negotiate and pay a separate fee for advice will be detrimental to many consumers.

These concerns are echoed in a recent (January 2013) report on practices in the financial advisory industry commissioned by the Monetary Authority of Singapore (“MAS”)¹¹ (at page 18):

¹¹ “Financial Advisory Industry Review Report on Recommendations of The Financial Advisory Industry Review Panel 16 January 2013”, http://www.mas.gov.sg/~media/resource/news_room/press_releases/2013/Annex%201%20%20Report%20on%20recommendations%20of%20the%20Financial%20Advisory%20Industry%20Review%20Panel.pdf

“An even more radical idea is to abolish commissions entirely and move to a ‘fee-only’ model. While the United Kingdom and Australia have adopted this model, it may be premature to impose a ‘fee-only’ model in the Singapore market. From a survey conducted by MAS, 80% of the respondents indicated that they would not pay a fee for financial advice. Thus, a ‘fee-only’ model may result in more Singaporeans being under-advised or under-insured. It is also not clear that fees will be lower than commissions. Indeed, it is possible that consumers may end up paying more.”

We believe it is incumbent on Canadian regulators, if they are inclined to emulate the moves by the UK and Australia to replace embedded compensation with an adviser charging regime, to carefully assess the impact in those jurisdictions on consumers at the lower end of the wealth and income scale who currently benefit from the access to pooled investing that trailing compensation makes possible.

We also would point out that in our view, the initiatives in the UK and in Australia are responses to unique consumer protection gaps and situations in those jurisdictions which are not present in Canada.

It would be a mistake for Canadian regulators to follow those jurisdictions. Both the UK and Australia experienced major scandals involving large losses incurred by investors. In the UK, these scandals typically involved large institutions and “mis-selling” of products that were unsuitable. In Australia investment scandals occurred in the context of their mandatory national superannuation scheme and the collapse of two prominent domestic firms, Storm Financial and Opes Prime. In both the UK and Australia there was a widespread view that the system had failed the public, the interests of intermediaries and consumers were misaligned, compensation played a large role, and systemic reforms were needed. On the other hand in Canada the notable financial scandals typically involved individual “bad apples” rather than institutions.

E. Conclusion

The present system for mutual fund investing offers Canadians tremendous benefits over alternative approaches to investing: professional management, financial and tax planning, managed risk, efficiencies of scale in trading of underlying assets, accommodation of small retail accounts, income tax reporting slips and low-cost.

Trailing commissions make it possible to offer consumers who invest small amounts access to pooled investing and investment management services at a low cost. Trailers compensate dealers and advisors in small amounts for the servicing of small accounts that simply would not be viable under a negotiated advisor charging regime.

We also submit that the actual harms that flow from conflicts of interest due to embedded compensation are insubstantial, while the harm to consumers that will result from eliminating embedded compensation on mutual funds is substantial. Eliminating embedded mutual fund compensation would limit consumer access to financial advice, particularly at the lower end of the wealth and income spectrum.

Advocis appreciates this opportunity to provide comments. Should you have any comments or questions, please do not hesitate to contact the undersigned, or contact Ed Skwarek, Vice President Regulatory and Public Affairs at eskwarek@advocis.ca, or by calling 416-342-9837.

Sincerely,



Greg Pollock, M.Ed., LL.M., C.Dir., CFP
President and CEO



Harley Lockhart, CLU, CH.F.C.
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Alberta Securities Commission
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