April 12, 2013

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

Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8
Attention: The Secretary

Dear Mesdames and Sirs:

RE: CANADIAN SECURITIES ADMINISTRATORS
DISCUSSION PAPER AND REQUEST FOR COMMENT 81-407 MUTUAL FUND FEES

INTRODUCTION

Thank you for this opportunity to comment on the CSA Discussion Paper concerning Mutual Fund Fees. As a "buy side" participant in the investment industry for my entire career, I have managed money and teams of portfolio managers providing investment services to corporations, pensions, individuals and mutual funds.

As the primary investment vehicle for most Canadians, mutual funds can provide professional management, diversification and shared expenses for small retail investors who could not otherwise access these capabilities. That Canadian mutual fund fees have not responded to competition from within the fund industry nor materially from other products such as index and exchange-traded funds that offer similar benefits at much lower cost, is a question that comes at a time when Canadians are not saving enough for retirement (Ipsos Reid, RBC, 2013) and taxpayer-supported social welfare systems are overextended. It is imperative that better and more cost-effective investing choices be available. The CSA discussion paper provides an excellent summary of product manufacturers, distributors, and consumers within Canada and other selected jurisdictions. Staff is to be commended for providing a very thorough study.

Despite decades of evolving regulation, a maturing and motivated consumer base, an unprecedented expansion of access to information, and an abundance of so-called industry “advisors”, the discussion paper shows that Canadian mutual fund customers remain largely unaware of what they are buying, the price they are paying, and the compensation and qualifications of the so-called “advisor” from whom they are buying funds. Plentiful choice and apparent competition have done little to improve buyer awareness or to lower fees.

SOME UNDERLYING PRINCIPLES AND ASSUMPTIONS

My comments on the discussion paper are based upon the following underlying principles of securities and capital markets regulation and assumptions:

1. Protecting investors and ensuring that markets are fair, efficient and transparent while mitigating systemic risk;

2. Full, true and plain disclosure is essential to market efficiency and transparency; and

3. An informed investor/consumer will make the most appropriate choices for their own best interests.

MISCONCEPTIONS AND UNINTENDED CONSEQUENCES

These principles are interdependent and can become distorted and dysfunctional through asymmetry of information between those who seek to sell products and those who buy them and by incentives that reward behaviour that may not be in the best interests of consumers. For example, the discussion paper points out that:

- 80% of mutual fund investors said their last purchase was made through a so-called “advisor”.

- 7 of 10 investors believe their so-called “advisor” has a legal duty to put the client’s best interests ahead of his or her own.

- 99% of investment fund and wrap assets under administration are distributed by so-called “advisors” who have NO DUTY to put their client’s best interests ahead of their own.

These findings establish that mutual funds are primarily sold through so-called “advisors” and that investors incorrectly believe these “advisors” have a duty to place client interests ahead of their own. However, as the result of sales incentives, funds may not in fact be selected in the client’s best interest, market transparency suffers, consumers remain uninformed and price discovery between mutual funds ceases. An unintended consequence of the existing regulatory and disclosure regime is that mutual fund manufacturers are best served by designing products primarily for so-called “advisors” based on compensation and not for investors based on risk and return. The discussion paper further confirms that:

- Trailing commissions as a percentage of total advisor compensation rose from 27% to 64% between 1996 and 2011.

- Self-regulatory organizations (SROs) do not require the advisor to tell mutual fund investors about trailing commissions.

- Since trailing commissions are generally embedded in management fees, trailing commission rates can be increased without security holder approval.

Growing so-called "advisor" dependence upon trailing commissions that are not required to be disclosed and that can be increased without unit holder consent can lead to concealed fees that may be subject to manipulation and may lead to something akin to "soft-dollar" costs and "secret commissions", neither of which improves information asymmetry.

ANALYSIS

Mutual fund manufacturers and so-called "advisors" benefit from the information asymmetry between reality and the investor's perceptions of a so-called "advisor's" duty to the investor. Because of this asymmetry, fees are not subject to the same competitive price pressures of other industries. The introduction of low cost index and exchange-traded funds over the past decade coincides with the peaking and modest abatement of mutual fund fees in Canada suggesting perhaps that only agents from outside the mutual fund industry can impact fees.

A number of ongoing staff initiatives attempt to address information asymmetry:

Point of Sale: The introduction of *Fund Facts,* a simplified version of the simplified prospectus, may be read by more investors and the inclusion of improved fee transparency is good. In the absence of Investment Industry Regulatory Organization of Canada (IIROC) or Mutual Fund Dealers Association of Canada (MFDA) requirements to do so, as the Mutual Fund Fee Discussion Paper confirms, additional disclosure of trailing commissions would be welcomed. However, if consumers do not understand that their so-called "advisor's" compensation conflicts with client best-interests, can point-of-sale disclosure address and impact the information asymmetry? Is it possible that investors feel they don't need to read investment disclosures because their so-called "advisors", acting on their behalf to protect them, have already done so?

Statutory Best Interest Duty: *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, the subject of CSA Consultation Paper 33-403,* raises the issue of the fiduciary duty of advisors to investors or lack thereof. Five concerns are identified: firstly, inadequate principled foundation for standard of conduct, secondly, asymmetry between client and advisor information and financial literacy; thirdly, the asymmetry between investor perception of advisor standard of duty and reality; fourthly, between the standard of suitability and best interests; and fifthly, applied conflict of interest rules being less effective than intended. If all advisors are required to adopt a best interest standard, the main impediment to informing consumers about mutual fund fees will have been addressed in theory, however such a standard is, I suggest, unenforceable without the realignment of compensation. As long as so-called "advisors" continue to receive incentives and primary compensation based upon product sales and not based upon growing client assets, then so-called "advisor" interests are not aligned and the potential for abuse and conflict of interest exists in every relationship. The asymmetry will always remain.

Cost disclosure, Performance Reporting and Client Statements: *Amendments to National Instrument 31-103 and Companion Policy 31-103CP*. Pursuant to mutual fund fees, these amendments provide for mandatory disclosure of trailing commissions. More disclosure is good only if consumers will read and comprehend it. There is no evidence that simplification, expanded disclosure or financial literacy programmes have had a discernible impact on fees over time. Could this failure in large part be associated with consumer's inappropriate trust that their so-called "advisors" will read all the material and make determinations in the investor's best interest, a practice that the mutual fund industry's incentive system does not promote or even support?

IIROC: Use of Business Titles and Financial Designations: This notice identifies the lack of standards related to business titles. Consumers are at risk if they assume higher service provider skills and experience than is, in fact, the case, and if they misunderstand the so-called "advisor's" duty to clients. Interestingly, a study commissioned by IIROC found that the vast majority of consumers could not remember what title was used. Implementing a regime that makes titles meaningful may help correct misperceptions about the skill levels attained and position and responsibility within organizations. However, many and perhaps most titles are used to enhance the stature of the so-called "advisor" in the eyes of the client, a possible distortion if the client is unaware that the so-called "advisor" is, in fact, a commissioned salesperson.

APPROPRIATE LEVEL OF REGULATION

What regulation can have the appropriate impact without unduly impeding or distorting free and open markets?

Dealing with the asymmetry of information and financial literacy between the buyer and seller of mutual funds cannot be adequately addressed simply by product disclosure. In theory, the so-called "advisor" is meant to level this asymmetry by acting for buyers. Not only is this not the case, the very existence of a so-called "advisor" in a relationship with a buyer who mistakenly believes that the so-called "advisor" has a legal duty to act in the investor's best interests, reduces the apparent need and motivation to read prospectuses and product disclosures.

What is required is "service provider" disclosure. To make existing and future disclosure effective, the principles of full, true, and plain disclosure must be applied to market participants who stand between the investor and investment products.

REMEDIES

If investor interests are aligned with advisor interests, financial product fees in general and mutual fund fees in particular would not be a problem because investors would have knowledgeable advocates working for them to seek and select the best values. Financial product manufacturers could concentrate on providing value for investors rather than be distracted by compensation schemes and trailing commissions.

There are two effective regulatory remedies for the current situation. The first is the one selected by the U.K. and Australian regulators in discontinuing the practice of advisor compensation being set by mutual fund manufacturers and is listed as Possible Change (vii) in the CSA Discussion Paper. The second is to apply the principles of full, plain and true disclosure to "service-provider" titles and to mandate use and disclosure in all forms of communication from positioning to font size.

Discontinue the practice of advisor compensation being set by mutual fund manufacturers: This approach effectively makes all advisors fiduciaries and requires them to negotiate compensation directly with their investors. Clients win by having their interests aligned with their advisors. In Canada, this remedy would align mutual fund buyer perception with reality.

Apply the principles of full, plain and true disclosure to "service-provider" titles and duties: The use of the term "advisor" in Canada is problematic. It implies a duty to a client that does not exist in mutual fund distribution at all, and in only limited scope among securities dealers. The term "financial advisor", used to describe financial planners who are MFDA licensed, may imply investment expertise that usually does not exist. The term "investment advisor" refers to IIROC licensed individuals who may or may not be qualified to offer discretionary portfolio management services but is used uniformly by IIROC member firms to describe dealing representatives. Current registration categories do not adequately describe duty to client nor form of compensation.

The duty so-called "advisors" have to assess product "suitability" for investors pursuant to mutual funds and other securities connotes a "fit" for an investor and is misleading. In fact such suitability relates only to a single product and not a portfolio. And as the discussion paper suggests, selection between equally suitable products does not mean the lower cost or more risk-appropriate one is selected. The unintended consequence of "suitability" standards has been to falsely assure investors that so-called "advisors" have acted in client best interests. Product suitability and portfolio risk are entirely different concepts but many market participants and regulators believe them to one and the same.

Examples of more descriptive titles:

- **Commissioned mutual fund salesperson** (MFDA) formerly: financial planner, financial advisor;

- **Commissioned securities salesperson** (IIROC) formerly: investment advisor, investment specialist, dealing representative;

- **Salaried single fund family salesperson** (MFDA bank branch) formerly: financial planner, financial advisor;

- **Fee-only discretionary advisor** (IIROC), fiduciary standard, formerly: discretionary investment manager;

- **Fee-only discretionary investment advisor/counsellor** (PM), fiduciary standard: portfolio manager

Giving investors an immediate understanding about the advisor's role and duty to clients will provide several ancillary benefits. Consumers will know that mutual fund transactions with commissioned salespeople will, like other retail transactions, invoke the principle of *caveat emptor* or buyer beware. Regulatory disclosures may be read more frequently as a result. Furthermore, appropriate service provider labelling will eliminate securities commission's implied endorsement of so-called "advisors" as fiduciaries.

SUMMARY

Fees are not the problem but a symptom of a distribution system with incentives that work against client best interests; a symptom of a manufacturing system with an emphasis towards distribution and away from investors; a symptom of a regulatory focus on presumptive rules rather than to broader principles.

Eliminating commissions is the best choice, but relabeling so-called "advisors" so that investors understand the true nature of their relationship seems like the very minimum action to take consistent with transparency and full, true and plain disclosure. Regulators insist upon this standard for products, we should insist upon it where the products meet the investing public, i.e. , at the "advisor". Some organizations that have benefited from the implied value of the title "advisor" may be loathe to give it up, but as the discussion paper clearly shows, investors have badly and consistently been mislead by it. It is time to correct this oversight.

In addition to the above, I have taken the liberty of commenting on the "Possible Changes" proposed in the discussion paper (see Appendix "A", attached)

Yours truly,

[SIGNED]

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APPENDIX "A"

POSSIBLE CHANGES

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

Aligning payment and services of trailing commissions is admirable but will only add to the mountains of disclosure that investors do not and will not read particularly when they rely on their so-called "advisors" to do so.

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

"F" class shares are available now. They are not promoted and do not attract many assets. Mutual fund companies have no incentive to promote "F" class shares because they conflict with their primary distribution channels.

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

This replication of the 12b-1 fee in the U.S. would make comparison of cross border mutual fund fees easier and would have several advantages over the current Canadian practice of embedding commissions. Disclosure and security holder approval of changes are the primary benefits. The cost of this disclosure in additional filing and paperwork will likely be substantial and may negatively impact overall fees to clients.

iv. *A separate series or class of funds for each purchase option*

While the principle of treating each class of security holder fairly is a good one, studies show that more choice actually impedes consumer decision making. Have mercy on an already beleaguered investor. Don't do this.

v. *Cap commissions*

Caps distort pricing and economic function by creating a misalignment of interests. The unintended consequence of capping commissions may be to give an advantage to financial institutions with ancillary products and services for which uncapped compensation exists. Banks and insurance companies will love this!

vi. *Implement additional standards or duties for advisors*

Statutory best interests and CSA Consultation Paper 33-403 have been discussed above. It is the most comprehensive way to deal with asymmetrical information and financial literacy. It is also the most expensive in terms of advisor retraining and qualification. Any organization with a large branch network will be stressed to train sufficient numbers of advisors to this high standard. The cost of such training will likely be borne by consumers. Worst of all, without realigning the compensation system, it is likely unenforceable. Conflicts of interest will abound.

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

This approach has been adopted by the U.K. and Australia for good reason. It is an elegant way to force advisors towards a fiduciary standard and align their interests with clients, force conversations about fees and services provided.