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June 5, 2017

British Columbia Securities Commission  
Alberta Securities Commission  
Financial and Consumer Affairs Authority of Saskatchewan  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
Financial and Consumer Services Commission  
New Brunswick Superintendent of Securities  
Department of Justice and Public Safety, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland and Labrador  
Superintendent of Securities, Northwest Territories  
Superintendent of Securities, Yukon  
Superintendent of Securities, Nunavut

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

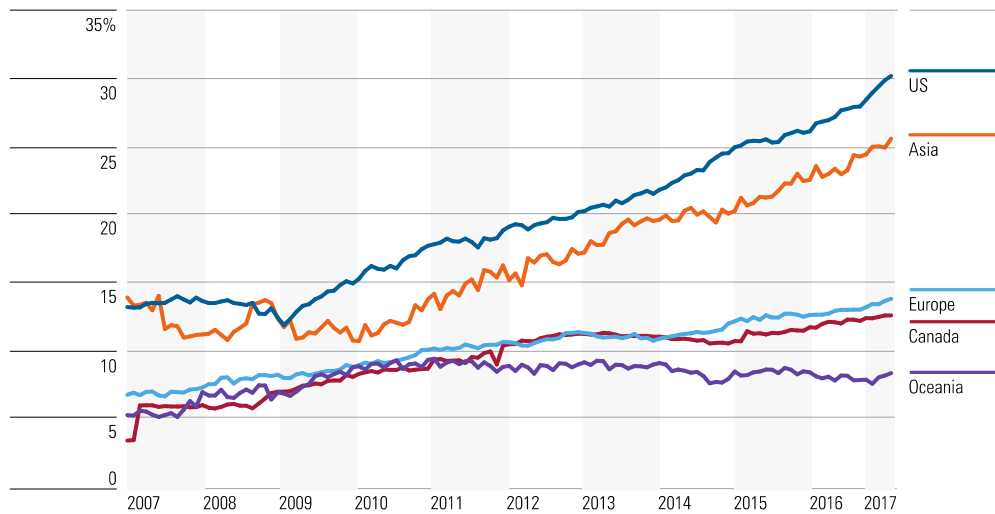
Me Anne-Marie Beaudoin  
Corporate Secretary  
Autorité des marchés financiers  
800, square Victoria, 22e étage  
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Montréal (Québec) H4Z 1G3

RE: CSA Consultation Paper 81-408; Consultation on the option of discontinuing embedded commissions

Ladies and Gentlemen:

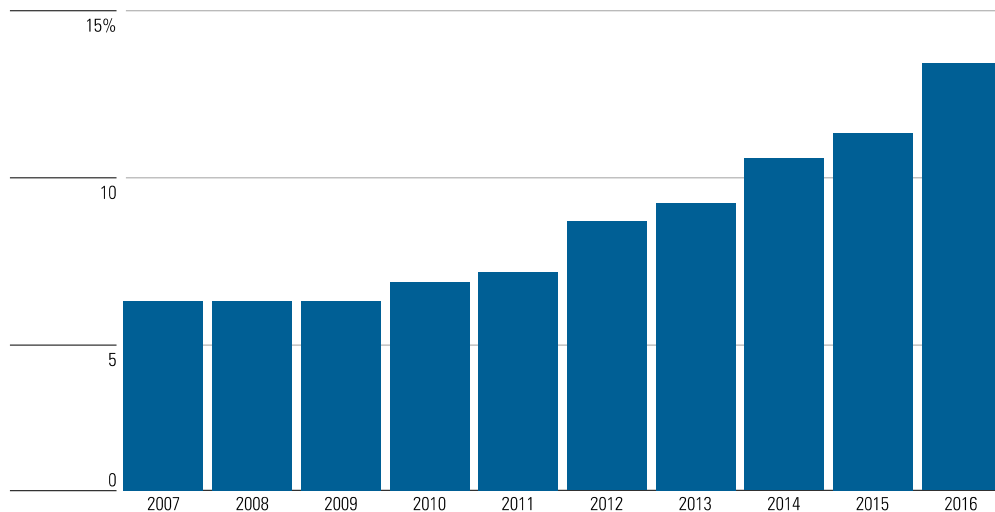
Morningstar Research, Inc. welcomes the opportunity to address the questions posed in the Canadian Securities Administrators' Jan. 10, 2017, paper discussing the proposed discontinuation of embedded commissions. Morningstar Research, Inc. is a leading provider of independent investment research, and our mission is to create products that help investors reach their financial goals. Because we serve individual investors, professional financial advisors, and institutional clients, we benefit from a broad perspective on the impact of the proposed rule and its possible effect on the advice that investors receive.

**Exhibit 1** Index Fund Share Across Major Markets, 2007-Present



Source: Morningstar. Data as of March 31, 2017.

**Exhibit 2** Index Fund Market Share, United Kingdom, 2007-16



Source: The Investment Association, Data as of January 31, 2017.

Morningstar believes embedded commissions should be discontinued because they align the financial interests of advisors with asset managers rather than with individual investors seeking advice. While clients' best interests are served by holding lower-cost funds, asset managers have an incentive to promote higher-cost alternatives from which they generate more revenue from fees. Asset managers use embedded commissions to give advisors incentive to favour higher-cost funds, creating a conflict of interest. For example, the commission paid to actively managed funds typically is at least twice that for passively managed funds.

**Exhibit 3** Historical Management Expense Ratios, 2011-15

Category	Distribution Channel	2011	2012	2013	2014	2015	2016	Change (2011-2016)
Canadian Dividend & Income Equity	Commission-based	2.29	2.29	2.3	2.29	2.29	2.26	-0.04
	Fee-based	1.22	1.22	1.22	1.22	1.2	1.16	-0.06
Canadian Equity	Commission-based	2.21	2.2	2.3	2.24	2.22	2.18	-0.03
	Fee-based	1.17	1.2	1.26	1.17	1.15	1.1	-0.07
Canadian Equity Balanced	Commission-based	2.32	2.32	2.34	2.31	2.3	2.29	-0.02
	Fee-based	1.26	1.29	1.27	1.24	1.21	1.21	-0.05
Canadian Fixed Income	Commission-based	1.53	1.56	1.55	1.55	1.54	1.53	0
	Fee-based	0.94	0.94	0.92	0.91	0.89	0.87	-0.07
Canadian Fixed Income Balanced	Commission-based	1.95	1.94	1.93	1.94	1.93	1.92	-0.03
	Fee-based	1.03	1.04	1.03	1.02	1.01	0.99	-0.04
Canadian Focused Equity	Commission-based	2.46	2.44	2.45	2.43	2.44	2.41	-0.06
	Fee-based	1.27	1.29	1.3	1.3	1.29	1.28	0.01
Canadian Neutral Balanced	Commission-based	2.23	2.2	2.2	2.17	2.17	2.15	-0.08
	Fee-based	1.18	1.16	1.13	1.1	1.09	1.07	-0.11
Global Equity	Commission-based	2.59	2.54	2.55	2.53	2.54	2.52	-0.07
	Fee-based	1.43	1.37	1.38	1.35	1.33	1.32	-0.11
Global Equity Balanced	Commission-based	2.5	2.5	2.48	2.46	2.45	2.43	-0.07
	Fee-based	1.34	1.31	1.32	1.3	1.27	1.24	-0.09
Global Fixed Income	Commission-based	1.91	1.89	1.91	1.91	1.82	1.8	-0.11
	Fee-based	1.1	1.08	1.13	1.08	1.01	1.02	-0.08
Global Fixed Income Balanced	Commission-based	2.21	2.16	2.14	2.12	2.08	2.07	-0.14
	Fee-based	1.24	1.14	1.19	1.13	1.1	1.08	-0.16
Global Neutral Balanced	Commission-based	2.38	2.35	2.32	2.31	2.29	2.29	-0.09
	Fee-based	1.24	1.25	1.24	1.2	1.18	1.17	-0.07
International Equity	Commission-based	2.43	2.41	2.42	2.38	2.36	2.37	-0.06
	Fee-based	1.28	1.27	1.29	1.28	1.24	1.24	-0.04
US Equity	Commission-based	2.29	2.23	2.31	2.28	2.27	2.23	-0.06
	Fee-based	1.28	1.21	1.27	1.22	1.19	1.17	-0.11

Source: Morningstar, Data as of April 30, 2017.

As a result, advisors in Canada overwhelmingly favour actively managed funds: Index funds constituted 1.3% of commission-based assets as of March 2017, virtually unchanged from January 2007. By contrast, total Canadian indexed assets overall grew from 3.4% to 12.4% over this stretch, thanks mainly to the use of exchange-traded funds by fee-based advisors, institutions, and do-it-yourself investors. Index funds also made inroads in most other major markets, especially the United States, as Exhibit 1 illustrates.

Morningstar expects discontinuing embedded commissions would accelerate flows into lower-cost active funds and index funds. After the United Kingdom introduced new rules outlawing trailing commissions in December 2011, index funds' market share rose sharply after years of stagnant growth, as Exhibit 2 indicates. Index fund assets grew from 6.9% to 13.5% of industry assets from

January 2012 through December 2016. When asset managers could no longer give advisors incentive to favour more-expensive active funds, fewer advisors chose them. We welcome such competition from cheaper passive alternatives, not to displace active managers but to pressure them to become cheaper.

It does not take an imaginative leap to envision what the post-embedded-commission landscape could look like. With increasing numbers of advisors adopting fee-based business models, the proportion of Canadian funds sold without commissions has grown markedly in recent years. While fee-based share classes accounted for 3% of advised fund assets in 2011, they now account for 15%, according to Morningstar data. Price competition was stronger in the fee-based channel over the period. For example, the average fee-based Canadian Equity management expense ratio fell 7 basis points from 2011-16, versus a 3-basis-point decline for the average commission-based fund in the category. We observed similar patterns across most major CIFSC categories, which we depict in Exhibit 3. Without embedded commissions to attract assets, fund managers compete, at least in part, on cost. Removing financial incentives to favour some funds over others encourages advisors to focus on investment quality, of which cost is an important indicator. This result is unambiguously good for fundholders: Lower management fees mean better returns for investors.

Proponents of embedded commissions often characterize the commissions as fees for advice. In most cases, however, these commissions are fees paid by asset managers in exchange for funds sold, not for advice. Under the embedded-compensation model, investors receive varying levels of service but pay a single, set price. Costs may be transparent but what investors get in return is not. Unbundling administrative and operational fees makes the cost of advice explicit. We anticipate that greater transparency will require advisors to offer services commensurate with the fees they charge.

Some have argued that discontinuing embedded commissions risks leaving investors who have relatively small balances without access to advice. But rather than abandoning or de-emphasizing these investors, we anticipate that the delivery of advice for this segment will change and technological innovations in advice will serve this segment. These solutions, commonly referred to as “robo advisors,” fill the gap between no-frills discount brokerages and full-service wealth managers. We view the rise of digital advice solutions as positive for investors, as these solutions democratize sophisticated asset-allocation models that had been available only to large institutions.

By inducing competition and lowering costs, improving transparency and accountability, and driving technological innovation, Morningstar believes investors will be well-served by discontinuing embedded commissions.

Very Truly Yours,

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Director of Policy Research  
Morningstar, Inc.