Via email

June 7th, 2017

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Response and Comment to CSA Consultation Paper 81-408 Consultation on the Option of
Discontinuing Embedded Commissions

Class A mutual fund shares have embedded remuneration/commissions called trailers. Regulators have the surprising notion that embedded due to its very nature - is bad. I believe this view to be incorrect.

Associating embedded remuneration automatically with price gouging or skewing is not a correct concept - not even close. As a deposit broker, I get paid a GIC commission and because all the commissions are the same there is no skewing. Extending this concept to the fund industry should not be difficult as I know it works 100% and is proven.

Many believe that "pay direct" by the investor is the one and only solution. They are calling upon the industry to find ways to mitigate the damage (to investors) caused by going to a single-choice "pay direct" model.

I think we should pause here and reflect just a bit. **Regulation should never be designed to hurt investors and asking the industry to find ways to mitigate the damage to investors is just not the right thing to do.**

Rather than ban embedded, regulators should be embracing the concept albeit in a slightly different manner.

My proposal:

FE, DSC and LL mutual fund classes of shares would be eliminated. Let the investor choose whether they want a *negotiated* embedded AUM fee/commission or a *negotiated* un-embedded AUM fee.

Almost all advisors will agree that after almost thirty years, trailer commissions have converged to become AUM fees - specifically for advice and service rather than for distribution. The front-end loads of yesteryear –of up to 9% are now set at 0% as almost all **advisors in Canada have completely eliminated their own front-end load commissions. In effect, advisers have skewed their own commissions to zero.**

According to current statements, the industry is being accused of the pervasive skewing of sales. According to the dictionary definition of pervasive, pervasive means widespread. With close to 30 years experience, I know one thing for sure – skewing is not pervasive –not widespread and I believe –is exceedingly rare.

Embedded remuneration (trailers) is set by the manufacturer of the product –not by the securities firms (excluding proprietary products) or their financial advisers. There have been accusations that sales will tend towards where compensation is the highest. Although this behavior describes the capital economy perfectly, regulators perceive it is a grave problem. Some studies conclude that skewing to higher compensation investment products (impacting sales) is pervasive however these studies did not divulge exactly how much skewing is going on or the degree of skewing. Advisers acknowledge that skewing probably exists somewhere but only as rare outliers.

Cummings is essentially correct – money will flow to where compensation is highest which will be to fee-based accounts that have no caps, are open-ended, not regulated to any degree and remuneration is controlled by the dealer's pay grid.

It is clear that the traditional transactional business for the purchase of securities is dying. Stock trading commissions for the average investor have plummeted over the decades and are just a few dollars per trade or are even free. Average trailers and commissions to advisers have been dropping along with mutual fund MERs. Front-end loads have all but disappeared. Trailers for money market funds have ceased to exist. Competitive pressures to reduce costs are everywhere.

The belief that banning embedded will result in immediate savings does not make sense. At best, separating out the commission from the product should only be a wash. It is similar to arguing whether the HST should be built into the product price or charged separately at the cash register. Either way –the price of the product to the consumer turns out to be exactly the same except I believe it won't be the same. Fee-based compensation could be higher than embedded based compensation for many investors.

The best mechanism to lower costs is through competitive pressures in the marketplace rather than through regulatory mandates.

The regulators appear to have come to the conclusion that anything embedded is bad but regulators have never regulated open-ended fees and appear reluctant to do so. Unfortunately, industry commentators **perceive trailers as evil incarnate and must be stamped out of existence – at all costs and at any cost.**

There is no logic to assume or believe that embedded is the cause of all evil. The regulators made sure that all fees and commissions be made 100% transparent and they have made it happen. Whether a disclosed commission is embedded or not is not relevant in an embedded society where all products and services have embedded costs.

However, what if we do stamp trailers out? And what should replace them?

How might this be done?

Eliminate commissions and trailers entirely. No front-end loads, no DSC fees, no low-loads.

Trailers have an inherent perceived flaw from a regulatory viewpoint. They are set by the fund company and the interactions are between the fund company, the advisor and the firms that the advisors work for. According to the paper, there is a potential for a conflict of interest as a higher trailer might potentially tempt an advisor to steer sales in that direction. How do we deal with the temptation of higher remuneration with a financial institution offering “too high” of a trailer or avoid the temptation to charge “too high” of a fee in a fee-based account?

Rather than let the industry or regulators set commissions and fees, why not **give the investor full control of what they are paying for their investment products and services.**

In the model I am proposing, **trailers cease to exist and would be completely replaced by embedded AUM fees (or commissions)** except there is an important difference. The AUM fee/commission is *negotiated* between the adviser and the investor. In other words, **embedded fixed trailers are replaced by embedded**

negotiable commissions. This would negate the need for an exclusive "pay direct" model.

This will also greatly reduce the large numbers of the "alphabet soup" of multiple classes of mutual funds.

If advisor embedded compensation is negotiated one-on-one with the investor in the same fashion as with fee-based accounts, then there can no longer be any skewing. It is eliminated instantly.

Embedded negotiable AUM fees (to replace trailers) can have a very significant advantage over traditional fee-based accounts. It may be possible that each embedded mutual fund AUM fee can be negotiated individually. **This is a very important and key difference. For example, moving a fixed income mutual fund with a fixed trailer of 0.50% to a fee-based plan will increase investor costs dramatically**. The investor moves from paying a 0.50% annual (trailer) to a lofty 1.0% to 1.5% annual fee (or more) in a fee-based account. **Fee-based plans charge a fee on <u>all holdings</u> in the account**. **All fee-based plans have an inherent conflict of interest to potentially tempt advisers to replace low commissions (fixed trailers) with much higher fees.**

In my proposed embedded negotiable AUM account*, the investor will have the ability to negotiate the AUM fee/commission on each holding.*

"Pay direct" fee-based accounts would continue to exist as they always have and fees remain negotiable as they always been. Fee -based accounts can also incorporate other negotiable fee structures other than just negotiable AUM fees – flat fee retainers or retainer fees based on tiered AUM, for instance. Or as an alternative, all AUM tiers, minimum account size and AUM fee schedules could be eliminated. The marketplace is proving that it can be extremely competitive without the need to regulate remuneration.

To eliminate "skewing" either make remuneration the same everywhere or make it different for each transaction (make it negotiable).

If embedded commissions are eliminated entirely, there will be mass disruption in the industry as such a regulatory ruling will effectively kill client-held accounts.

There will be massive inflows to set up nominee accounts and investors will be forced to pay expensive annual trustee fees. For small accounts it makes no economic sense to pay a $125 annual trustee fee (plus HST) plus some Dealers charge additional fees for additional registered plans. Full transfer-out fees ($250 + HST) are also notoriously expensive as well.

As a result, **regulators will likely lose future regulatory control over fees. It would be very difficult for any regulator to regulate open-ended fees or to regulate advisor pay grids.** Investor advocates should pay attention that **replacing lower embedded fixed commissions with higher fees may not be the result they really wanted or in the best interest of all investors.** And soon, we will be having conversations about the inherent conflicts of interest that potentially, all fee-based plans have. It is perhaps naive to assume that fee-based "pay direct" plans will eliminate all conflicts of interest. **Fee- based will never eliminate conflicts of interest- they merely create *different* conflicts of interest.**

Moving from client held accounts to nominee fee-based structures could result in increased costs to investors as fees for fee-based accounts could be higher than fixed trailers –especially for small or average investors.

Unfortunately**, investors will pay the price with increased fees and less access to advice** as the industry is forced to go "upscale". When we see terms like "mitigating damage" you can be assured they are referring to small or average investors as collateral damage. **Surely this is not in the best interest of the average investor.**

Based on the paper's comments, I think it is outside the scope and mandate of any regulator to suggest that the industry reduce profit margins or tout specific investments. **Those investment and risk decisions must always be made by the individual investor depending on their personal circumstances. In all cases, the regulatory role should be seen as having a neutral stance –neither favouring one investment product over another or one industry over another.**

Proof of harm

Not much has been written about the *psychology of money* with respect to issuing a new bill or fee to an investor or what an investor actually prefers. The tendency

in the investment business is for advisers, advocates, regulators and industry participants are to tell investors what their preferences should be. Perhaps we should be asking investors what *they* prefer.

So how will investors react to being forced to give up their all-in-one embedded pricing and be handed a new bill for service and advice?

I contacted one of the world's best known behavioral economists (**Dan Ariely of "Predictably Irrational" fame**) and asked him ***what the specific impacts on investors would be if investors in Canada were billed separately for their investments*.**

Dr. Ariely explained to me that if a client who has $1 million dollars invested in a savings account, for example, and pays 1% asset under management a year usually doesn't express any concerns***. However, Dr. Ariely argues that if a client had to directly pay $10,000 a year, they probably wouldn't do it. The reason is that people may not seek advice if they have to pay for it directly.***

Therefore, according to Dr. Ariely, ***if Canada bans embedded commissions and starts to bill investors directly, investors may refuse to pay, and if they do they will be upset*. *Investors may not seek advice, may stop investing or may not be put in the correct investments.***

Dr. Ariely's research suggests that forcing investors from embedded pricing to separate billing of fees could have dire consequences.

A single choice fee-based model is not a panacea –not even close. Fee-based plans have been around a long time and have had a relatively long track record. Have they caused advisors to massively pursue the cheapest investments possible? Or convert en-masse from active management to passive ? Advisers transferred their existing Class A shares to Class F and recommended the same investments from the same fund companies. If the embedded model is banned, advisers would be mandated to move the same funds from one account to another - with any additional financial costs borne by the investor. I see financial benefits to advisers but I am not seeing benefits to investors who have to pay more in a fee-based account for the exact same investments. For many investors, they are economically better off in less expensive Class A embedded mutual funds.

Considering financial advisers front-line role with investors, I am greatly disappointed that advisers are largely uninvited to participate in the regulation of their own industry. Advisers are not present in many (if any) regulatory committee role and it seems we have very little input in the regulatory process. That omission, I feel, is a shame.

Conclusion & Recommendations

I would recommend that **both models be retained** with some changes to all-in pricing models. Whether a fee (or commission) is built-in or not, mathematically – it comes out the same but many investors like and prefer all-in pricing. Regulators may **consider making all compensation negotiable**, **embedded or not.**

FE, DSC and LL mutual fund classes of shares could be eliminated along with all trailers. Let the investor choose whether they want a *negotiated embedded* AUM fee/commission or a *negotiated un-embedded* AUM fee.

Financial advisers can bring a lot to the table. Financial advisers should play a greater role in the regulatory process and work towards better regulation of the investment industry.

Respectfully,

Glenn Szlagowski
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