June 8, 2017

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

Me Anne-Marie Beaudoin
Corporate Secretary
Authorité des Marchés financiers
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Sent via Email: comments@osc.gov.on.ca, Consultation-en-cours@lautorite.qc.ca

Re: CSA Consultation Paper 81-408 Consultation on the Option of Discontinuing Embedded Commissions

Dear Sir/Madam:

Executive Summary

It is logical that the prosed changes to embedded commissions would be indirectly beneficial for the exempt market, as it effects a smaller proportion of our products and will create grave systematic risk for mutual fund dealers and independent brokerages. However, as indirectly beneficial as it could be for the exempt market, it is bad policy. Therefore, NEMA is against the proposed changes stated in CSA Consultation Paper 81-408 on the Option of Discontinuing Embedded Commissions. As an alternative, NEMA is supportive of investor choice through diversity in dealership business models in Canada, and transparency of compensation. It is concerning to us that the research presented in the proposal focuses on the micro results of investors paying more fees when working with advisors as opposed to the macro results of investors who work with advisors accumulating more wealth.

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About Us

The National Exempt Market Association (NEMA) was originally founded in 2011 as the Western Exempt Market Association. We are an organization dedicated to the growth of the Canadian Exempt Market's public profile and the improvement of its reputation. Through our members, NEMA has firsthand insight and knowledge of the operation and corresponding needs of the Exempt Market in Canada. By nature, our members are generally small businesses that raise capital for other small businesses. As such, our members are much more vulnerable to changes in securities laws than larger firms and organizations who have the resources, both legal and financial, to absorb and adapt to such changes. NEMA appreciates the opportunity to comment on the CSA Consultation Paper 81-408 Consultation on the Option of Discontinuing Embedded Commissions.

Process of Compiling this Report

This response is a compilation of NEMA membership views from the exempt market. NEMA has been active in soliciting member and stakeholder feedback. In addition to a vast amount of email correspondence, NEMA participated in one-on-one conversations with members. Please note that this response addresses only those specific questions in the consultation paper that our members have indicated to be of the greatest importance, and compiled them into one response.

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

It is outside the scope of the regulator's mandate to dictate market conditions, especially around remuneration structures for the private sector. The free market develops that based on stabilizing revenues and investor appetite for compensation models. Embedded commissions, if fully disclosed, increase alignment of the advisor with the investor (as they do not have to 'eat what they kill' and have a steady income stream). It is not in the investor's best interest to work with a brokerage or advisor that does not have a relatively consistent income stream, especially in a down market. NEMA asks the CSA to reflect on the compensation model options that Dealerships will be left with, whether it be fee only or salary with quotas, and reflect on the consequences of that. It is of our opinion that there will be far fewer dealerships, and the ones that remain will inevitably consolidate, leaving investors less choice and, in some cases, only bank provided options.

In addition, if embedded commissions are eliminated – they should be eliminated across the board. If enacted, the CSA should extend such a ban to all embedded structures in securities raises, including initial public offerings, banking products and insurance related products.

NEMA is not recommended a blanket policy of embedded commissions, but is illustrating that it is unreasonable to have these expectations for one area of distribution over the other.

NEMA feels compensation models need to be flexible for dealerships advisors, and the investors they serve. As an alternative to eliminating embedded fees, the full disclosure of such fees should be communicated between advisor and client at the time of the first phase of the sales cycle, when the mutual expectations are defined and agreed upon. This is not to say fees should be bartered, as one would do for a used car, but that the fees are stated and understood upfront.

Commission and related expense disclosure are disclosed in the exempt market, and have been for decades. The commissions are disclosed on the Risk Acknowledgement Form,[1] and the investor has to sign off on them before the sale. For retail investors, The risk acknowledgment form in our industry has always stated very clearly that amongst the real risk potential of losing all invested funds, and that the advisors recommended the product is being paid X for placing the investor in the deal.

Commissions and other related management expenses are disclosed in an Offering Memorandum (OM). Only about 20% of exempt market products currently have embedded forms of compensation, so it is understood that this is more of an issue with publically traded mutual funds. Since the real concern is about embedded fees in the Mutual Fund industry, a possible solution could be to create a Risk Acknowledgement Form for the mutual fund industry that indicates the potential risk of loss, and clearly states what the commissions and fees are relative to the fund being purchased.

In addition, as stated in the consultation paper, the results of the disclosure regimen of CRM II policy changes have just been implemented, which outlines what clients are paying for the services provided. The possible benefits and issues of the CRM II structure have not been discerned yet, so making such material industry policy changes at this time is rushed and duplicitous. We are cognizant that the regulators do not value disclosure models, and NEMA published a critical assessment[2] about the weak research methodology of the Cain, Loewenstein & Moore[3] studies from which this assumption is based.

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[1] The Client Acknowledgement form is included in NI 45-106

[2] The Debated Impotence of Disclosure: http://theprivateinvestor.ca/the-debated-impotence-of-disclosure/

[3] *The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest* by Daylain M. Cain, George Loewnstein, and Don A. Moore. Published January 2005 by The University of Chicago; and *When Sunlight Fails to Disinfect: Understanding the Perverse Effects of Disclosing Conflicts of Interest* by Daylain M. Cain, George Loewnstein, and Don A. Moore. Published January 2010 by the Journal of Consumer Research.

The results indicated that the advisors gave higher values to the estimators under the direct conflict condition rather than the control condition. The values were higher still if the conflict was disclosed. The researcher's conclusion was that disclosure gives advisors a moral license to mislead the client. What the researchers also found interesting was the way the estimators acted with the information under the different groups. Estimators discounted the values from advisors, but they did not discount them enough to compensate for the additional premium the advisors put on the coin value they recommended to estimators, and estimator guesses were more inaccurate in the disclosure condition. From this, researchers concluded that disclosure is actually harmful for the estimators.

The validity of generalizing the results of this study to financial services (or any other industry) are limited. First, this was a game, similar to the game of bluff, there was no explicit moral or ethical obligation for the advisor to act in the estimator's best interests. In addition, there were no consequences for the advisor not to act in their own best interest. Second, the conflict of interest was direct, meaning the advisor profited at the estimator's loss, this total non-alignment would not happen in industry, as reality is much more complicated than that, especially when factoring in reputation risks. Third, there was not an option for investors not to play, or 'invest,' which is a consequence of real world scenarios. Finally, the advisor had very little information, they were given a range of money in the jar, but not the actual value, so advice, biased or not, was a guess.[4]

Similarly, It is concerning to us that the research presented in the proposal, such as the CSA commissioned paper, *A Dissection of Mutual Fund Fees, Flows, and Performance* by Douglas Cumming[5] generally draws conclusions that a client's investment performance is reduced when they pay embedded compensation to an advisor, so investors are being harmed by investing in recommended funds versus do it yourself (DIY) or low-fee models. In the micro results of investors paying more fees when working with advisors as opposed to the macro results of investors who work with advisors accumulate more wealth.

However, household finance does not fit into any clean textbook models, as there is complexity in conflicting goals, emotional issues, and subjective opinions on 'value' where advisors play a significant part, and should be compensated accordingly. The value of the advisor has been

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[4] The Debated Impotence of Disclosure: http://theprivateinvestor.ca/the-debated-impotence-of-disclosure/
[5] Retrieved from: http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20151022_81-407_dissection-mutual-fund-fees.pdf

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ignored. For example, one robust industry study in the UK by Old Mutual[6] found that consumer's outcomes are more positive when consumers attain investment advice, with the average retirement income at 17,168 euros without an advisor, versus 20,873 euros with advice. Interestingly, when advice is paired with concrete goals, the average retirement income rose again to 24,175 euros – that is a significant increase in overall prosperity outcomes, and indicates that micro investment outcomes should not invalidate overall investor macro outcomes of overall wealth accumulation.

Concluding Remarks

NEMA is optimistic that the CSA will contemplate the comments received by us, and other industry participants, about the detriment of these proposals. NEMA recommends looking at how CRM II and other recent new legislation affects the market before enacting further changes. Implementing policy because a few other Commonwealth countries[7] have implemented policy to transition to fee only is, in our opinion, not a strong enough reason. Independent non-commissioned research should be looked at for this policy consideration, and in a few years the UK and Austria will be an ample case study and provide good guidance. In addition, enforcement actions against rogue advisors that harm investors are also recommended.

For further elaboration on our views or for questions, please contact Dr. Pettipas at cora@nemaonline.ca or 403-992-9809.

Regards,

Dr. Cora Pettipas **PhD, DBA, CFP, FCSI** — President

Craig Skauge — Chairman

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[6] The study is called *Retirement income uncovered: The new normal*. Retrieved from: https://www.oldmutualwealth.co.uk/products-and-investments/pensions/pensions2015/retirement-reports/

[7] The UK, Australia and the Netherlands