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June 9, 2017

VIA E-MAIL

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

Attention:
The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8
comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal (Québec) H4Z 1G3
consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: Canadian Securities Administrators Consultation Paper 81-408: *Consultation on Banning Embedded Commissions* (the "Consultation Paper")

We are writing in respect of the request for comments dated January 10, 2017 on the Consultation Paper. We appreciate the opportunity to comment on these important matters.

Invesco Canada Ltd. is a wholly-owned subsidiary of Invesco, Ltd. Invesco is an independent investment management firm dedicated to delivering an investment experience that helps people get more out of life. As of April 30, 2017, Invesco and its operating subsidiaries had assets under management of approximately US$841 billion. Invesco operates in 20 countries in North America, Europe and Asia.

Invesco Canada is registered as an Investment Fund Manager ("IFM"), an Adviser and a Dealer in Ontario and certain other provinces. Our investment products are primarily bought by and sold to retail investors and institutional investors. As such, we take a great interest in regulatory discussions that impact those investors. Please note that we have responded to the consultation questions in an appendix to this letter.

For many years now in the debate over mutual fund and dealer fee structures, Invesco has championed the concept of investor choice. We believe this is important because not all investors are the same, and not all investors need, want or require the same fee structures. For some investors, subscribing for mutual funds on a front-end commission basis makes the most sense, for some fee-based accounts make sense, and for others purchasing under a deferred sales charge ("DSC") option makes the most sense. We do not believe the Canadian Securities Administrators (the "CSA") has exhibited any appreciation for the reasons for these different approaches nor does it seem interested in doing so, especially once it has determined that some of these options give rise to conflicts of interest. Most disturbingly, we find the conflict of interest analysis in the Consultation Paper very weak; rather than explaining how it views the conflict of interest under each purchase option or fee model, the CSA has taken the conflict of interest as "received wisdom". In our experience, adopting received wisdom rather than reasoning out a concept leads to serious errors in analysis and poor outcomes. Because of our championing of investor choice and the CSA's overreliance on received wisdom, we cannot support the CSA initiative to ban embedded commissions. We do not close the door to eventually banning embedded commissions, but, as discussed below, we believe that would be premature at this time.

Notwithstanding the foregoing, we acknowledge the regulatory concerns raised by the CSA in the Consultation Paper. While there are many statements contained in the Consultation Paper with which we disagree, especially those that appear to be mere speculation[1], there are also many valid points made that simply cannot be ignored. Having

[1] See, for example, Consultation Paper pages 51 (about declining fund costs due to fund size), page 52 (on the costs of simplifying fund series), page 52 (entry of lower-cost producers), page 53 (smaller emerging asset managers),

considered the issues raised in the Consultation Paper and other major initiatives over the last several years, we believe the specific regulatory concerns raised by the CSA can be addressed with the following:

1. Prohibit all DSC purchase options; and

2. Set (not cap) trailing commissions at 1%.

While we believe the DSC has its use, we believe it has been distorted over time so as to no longer be in the public interest. We believe setting trailing commissions eliminates the conflict of interest that arises when a mutual fund is recommended or sold based on the rate of trailing commission. While this does not address the conflict of interest that arises from dealing representatives recommending products that pay trailing commissions over those that do not, we believe market forces are well underway to address that issue, primarily through the move to fee-based accounts, the rise in exchange-traded funds (both active and passive), and the increase in discretionary managed accounts. As such, regulatory intervention is not necessary and threatens to disrupt market forces that are behaving in an appropriate manner.

<u>The Trailing Commission Conflict</u>

According to investor advocates and the CSA, trailing commissions are inherently bad because they create conflicts of interest. Unlike other conflicts of interest that the CSA believes can be mitigated, the essence of the Consultation Paper is that these conflicts cannot be mitigated and, therefore, a ban is required. When one considers the range of conflicts of interest inherent in the wealth management industry and the numerous ones that the CSA has decided not to ban (see CSA Staff Notice 33-318 *Review of Practices Firms Use to Compensate and Provide Incentives to Their Representatives*) it is hard to comprehend the push behind the current consultation. As such, it is important to properly identify the conflicts of interest arising from trailing commissions.

In our view there are two types of conflicts that arise from trailing commissions:

1. A dealer may recommend one mutual fund over another not on the merits of the investment but on the basis that the recommended mutual fund pays a higher rate of trailing commission than the non-recommended fund, thus enriching the dealer.

2. A dealer may recommend a mutual fund over another investment product type because the mutual fund pays a trailing commission and the other product type does not.

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p.53 (reduction of fund management fees), page 53 (50 bps MER decline due to entry of low-cost providers), pp.54-55 (shift to passive), page 58 (15 bps for online advice), p.60 (lack of outperformance of fund-of-fund products), p.63 (that banks are indifferent to which product a client buys), pp.64-65 (UK cross-subsidization rule as limiting introduction of other delivery models), p.65 (no anticipated change in fund products being recommended by integrated dealers), p.66 and elsewhere (the entire notion that retail investors can negotiate fees)

The first type of conflict was the subject matter of the Cumming Report, commissioned by the CSA following the comment period for CSA Discussion Paper 81-407. Prof. Cumming collected data from a statistically significant portion of the fund industry and ran a series of regression analyses to determine the relationship between sales, performance and certain variables, such as commissions, fee-based accounts, proprietary funds distribution, etc. Prof. Cumming arrived at several conclusions the most important of which for present purposes is that the higher the rate of trailing commission, the greater the sales of the fund regardless of fund performance. In other words, Prof. Cumming found that a poor performing fund can mitigate the impact of performance on flows by paying a higher trailing commission. This conclusion is unassailable.

More controversially, Prof. Cumming sought to determine the cost to the investor as a result of this conflict by determining the "negative alpha effect" of trailing commissions in various scenarios. Whereas "alpha" is generally used to mean the value added by an investment professional relative to a pre-determined benchmark, the negative alpha effect shows what the cost is, in terms of performance, of the variables referred to in the preceding paragraph. In our view, it is this latter conclusion, which is less robust than the first conclusion noted above, that is driving the CSA's clear preference[2] that investors do not invest with active managers, using financial advisors. While individual CSA members are entitled to opinions, acting on this particular type of opinion is far beyond the scope of a securities regulator and there is no authority for this in the *Securities Act* (Ontario) or the equivalent statutes in other CSA-member jurisdictions.

The second conflict is based not on any purportedly scientific evidence and, thus, is dubious. While it is true that mutual funds pay trailing commissions, to suggest that is why they are recommended investments betrays an understanding of retail financial services, investment products and options, and investor needs. Mutual funds are simple to understand and, notwithstanding the myriad critics who have already submitted comment letters and, frankly, would like nothing more than to see the mutual fund industry disappear, they provide better disclosure to those who care about disclosure and/or want to know about their potential or actual investment, than any other investment product offered in the world. Most mutual fund investors have had positive experiences with mutual funds and that is an important aspect of their popularity.

For many years IIROC dealers have offered to their clients the opportunity to invest in separately managed accounts ("SMA") and unified managed accounts ("UMA"). This comes under several models but, on balance, an SMA is like a mutual fund with the primary differences being (a) the investor pays the management fee directly to the dealer, and (b) the investor holds the portfolio securities that an equivalent mutual fund would hold whereas for a mutual fund the investor does not have ownership of the portfolio securities. In contrast, a UMA may hold any type of investment product and is not limited to stocks and bonds. While the investor price for a SMA/UMA is controlled by the dealer, the price is often (though not always) lower than that for a mutual fund. Regardless, Canadian investors have not flocked to

[2] See Consultation Paper, pp. 54 and 55

SMAs/UMAs, although we acknowledge growth rates are high for SMAs/UMAs and this continues to be a focus for full service dealers.

When an IIROC client participates in a SMA/UMA program, the client pays an asset-based fee for the account. Put differently, the management fee paid to a mutual fund (inclusive of trailing commission) is replaced by the asset-based fee. In the case of the mutual fund, only the trailing commission goes on the dealer grid, but on the SMA/UMA, the full fee goes on the grid. Both fees are treated similarly on the grid so where an SMA/UMA might charge 1.75% and the mutual fund trailing commission is 1.00%, the advisor receives the same proportion of these fees. By the laws of mathematics, therefore, the advisor is always better off if the client invests through a SMA/UMA. Therefore, if trailing commission rates drive mutual fund sales, you would expect SMAs/UMAs to have eaten mutual funds for lunch long before the present day. However, that has not occurred. How does the CSA explain this phenomenon? The CSA theory, underpinning the notion that investors are in mutual funds because of trailing commissions, seems rather absurd because the CSA is effectively saying that the dealer is happy to take significantly less revenue in order to “deceive” the investor over fees. Note that the all-in fee for the SMA/UMA is typically lower than a Series A mutual fund management expense ratio (“MER”) so this should be an easy sell to an investor.

With the foregoing understanding of the conflicts of interest raised in the Consultation Paper, we can now better consider the concepts set forth therein.

Consultation Paper Concerns

Upon our initial review of the Consultation Paper, we had very negative reactions. While the CSA included much data in the Consultation Paper, some of it surprised us and much of it was, in the context of the Canadian regulatory regime, irrelevant. Yet such “facts” formed the basis for the CSA’s proposal. While we will not and cannot address every deficiency in the factual background included in the Consultation Paper, we will address several of significant concern and relevance.

What Advisors Sell And Why

The CSA believes that dealers and their representatives sell funds that compensate them the best or focus only on funds that pay a trailing commission.[3] We believe there is merit in the first part of this assertion – and we address that in our alternative proposal – but we do not believe there is merit in the second part of this assertion. It is our view that many dealers would prefer that their clients switch to fee-based accounts. The reason for this is twofold, yet simple: dealer compensation is generally higher in a fee-based account than for a commission-based account; fee-based accounts provide dealers with a steady, predictable revenue stream whereas commission-based accounts do not.

[3] Consultation Paper, p.3

➢*Higher Compensation In Fee-Based*

The reality is that mutual funds that pay trailing commissions and are sold on a sales charge (or front-end) basis generally pay 1% for equity funds and 0.5% for fixed income funds. Dealers are typically permitted to also charge an upfront commission to their clients for these purchases but our experience is that this is quite rare. According to our internal records, over 94% of Invesco Canada-managed funds sold on a front-end basis are sold without the dealer charging an upfront commission.[4] Therefore, in those cases, the dealer compensation is the trailing commission only. This must be compared with the fee charged on fee-based accounts. In the Consultation Paper, the CSA notes the dominance of Canadian bank-owned dealers in the distribution of mutual funds, all of whom offer fee-based accounts so it is appropriate to look to these institutions for comparative purposes. Our research indicates that the biggest dealers in Canada typically charge a fee of 1.50% for accounts that are less than $500,000 and in many cases the charge is 1.75% for such accounts. It seems rather obvious, therefore, that these dealers would prefer that clients be in fee-based accounts and if dealers are focused solely on higher compensation, as the CSA asserts, it would be irrational for dealers to offer any fee option other than asset-based fees. This fee discrepancy also raises the question of the extent to which we should be concerned with the conflicts of interest that arise from embedded commissions: is eliminating that conflict worth a 50-75% increase in the cost of advice for investors? While it is difficult to quantify relative value propositions such as this, we do not believe that such a price increase is warranted in the circumstances. While we understand the CSA may not agree that this increase will occur[5], there is no basis for this belief. It is not clear to us how an increase of 50-75% in fees is good for investors, even if it eliminates underlying conflicts.

Under the DSC option, the dealer typically does receive greater compensation over the life of the investment as compared to what it would receive from a fee-based account. As explained further below, in our opinion, the concept and economics of the DSC have been eroded over time such that the initial premises no longer apply. We are also aware of real abuses with DSC and we would agree that eliminating the DSC is an appropriate regulatory response. As such, in the balance of our comments, we assume away the DSC and further assume that the only commission-based option is a front-end option.

➢ *Fee-Based Provides More Predictable and Stable Revenue Stream*

We do not intend to dwell on the second reason asserted above as to why dealers prefer fee-based accounts other than to note that, as a simple matter of good business, any business prefers a predictable revenue stream to an irregular one and part of the dealer revenue in commission-based accounts is variable and unpredictable. We note that dealers may have other reasons for preferring fee-based accounts, including oversight and compliance.

[4] See comment letter dated April 12, 2013 of Invesco Canada Ltd., responding to CSA Discussion Paper 81-407, p.3.
[5] Consultation Paper, p.58 and p.89

Lack of Understanding By Investors and Resulting Impacts

The CSA states that "due to their embedded nature and complexity, [trailing commissions] inhibit the ability of investors to assess and manage the impact of dealer compensation costs on their investment returns."[6] In our opinion there is much wrong with this statement. At best, this statement is mistimed.

We do not agree that the mere fact that a fee is embedded means investors do not understand the fee. While this is certainly possible, there has been tremendous publicity around trailing commissions for several years due to CSA publications, investor advocacy, and media attention. To the extent investors do not understand the fee, the CSA has sought to remedy this in two ways: Fund Facts document disclosure; and the CRM2 report on charges and other compensation. The Fund Facts documents are now given at the point of sale and investors receive detailed information about trailing commissions in the report on charges and other compensation. These are new initiatives that will take time to achieve the desired results, although a recent report published by the British Columbia Securities Commission demonstrates that despite investors receiving CRM2 reports for the first time only this year, all key metrics around understanding fees, discussing fees with their advisor, and the ability to evaluate the service received in relation to the fees paid, have significantly improved.[7] While the CSA states that the proposal contained in the Consultation Paper is complementary to these earlier proposals which are now regulation, it is not clear why that is so. While trailing commissions remain embedded, the CSA statement implies that makes them opaque, but these earlier initiatives directly address that issue. The purpose of the Fund Facts document, regardless of when delivered, is to make the disclosures less complex. When the report on charged and other compensation and the Fund Facts document are read together, the trailing commission is not complex.

As a result of CRM2, the trailing commission paid on behalf of the investor is laid bare for the investor. As a result of that initiative, there is no difference in clarity for an investor between asset-based fees paid to the dealer directly by the investor and trailing commissions paid indirectly to the dealer on behalf of the investor through the IFM. Therefore, if investors cannot assess and manage the impact of trailing commissions on their investment returns in a CRM2 environment, it follows that they cannot do so with a fee-based account, which receives the same reporting under the regulations, and the CSA argument falls short.

We note further that investment performance for mutual funds must be presented on an after-fees basis to the extent the fees are charged by the IFM. This implies that a Series A return is an all-in number, whereas a Series F (or any fee-based series') return is misleading since it does not include the asset-based fee paid by the client directly to the dealer. In other words, the client return in Series F is overstated since it does not account for the fee, whereas the Series A return is correct since it does. The CSA has actually acknowledged the validity of this point through the investment performance report mandated under CRM2, which

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[6] Consultation Paper, pp.3-4

[7] Innovate Research Group, commissioned by the British Columbia Securities Commission, "Investor Readiness for Better Investing, 2016-2017 Panel Study: Part 2", April 26, 2017.

requires investment performance to be reported at the account level which has the effect of taking into account the asset-based fee.

That the lack of understanding and confusion cited by the CSA exists is not at all surprising. The CSA could have avoided this when it mandated preparation by IFMs of the Fund Facts document but chose not to. In our comments at the time, we requested that Fund Facts documents not be separated by series in order for investors to be able to compare fees and compensation among different series of the same fund. This would show investors – or at minimum give them the ability to determine – which fee structure makes most sense for them. Instead, the CSA chose to obscure this information by requiring a separate document for each series with the full knowledge that investors will most likely receive a Fund Facts document of the same series for multiple funds but not for multiple series of the same fund. The solution to this is not to eliminate compensation options but rather to ensure proper and appropriate information is provided to investors.

Investment Fund Managers Rely More On Trail Than Performance to Preserve Assets

The CSA states that "Investment fund managers who pay embedded commissions to dealers may be incented to rely more on those payments than on generating performance to attract and preserve assets under management."[8] This statement is insulting because it ignores the realities of the marketplace. Most IFMs that pay trailing commission pay the same rate, accordingly, there is no incentive to rely on those payments to preserve assets. Assets are preserved by performance. It is true that some IFMs pay trailing commissions above the standard 1% and those IFMs do tend to attract a disproportionate amount of assets regardless of performance. We agree that is wrong and that it gives rise to a regulatory issue. Our proposed solution to these issues addresses this problem fully.

We note that this problem is of the CSA's own doing. For many years, mutual funds that paid trailing commissions paid up to 1%. At some point, some companies started paying a higher rate. The CSA takes the position – with which we disagree, as discussed below – that the trailing commission is compensation for service. Yet, the CSA issued receipts for all of these prospectuses without ever asking how the higher trailing commission is justified. While securities regulations do not have a line item to address this issue, regulators do have a public interest power and it seems that such would be apt for use in this instance. We question why the CSA has not done so and continues to issue receipts for prospectuses with above market trailing commissions.

Commission Conflicts Diminish Focus on Risk-Adjusted Performance

The CSA states that "the research that we have gathered and reviewed suggests that this inherent conflict of interest diminishes the investment fund manager's focus on risk-adjusted outperformance, thus impairing investor returns."[9]

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[8] Consultation Paper, p.9
[9] Consultation Paper, p.10

This assertion is provided with no basis whatsoever. While the report prepared by Prof. Cumming shows correlative effects between trailing commissions and performance (which is obvious through the application of simple math), the CSA statement above is a statement about causation. This demonstrates an important misunderstanding by the CSA on how portfolio managers ply their trade.

At our firm, the value of assets managed by a portfolio manager has no bearing on their compensation. Rather, each portfolio manager has a base salary, which is designed to constitute a smaller portion of their compensation. The vast majority of compensation is based on a bonus structure, which can be as high as several times base salary, that is tied primarily to fund performance compared to peers in the category. That is, the portfolio manager has no incentive under this structure to retain assets and has strong incentive to outperform. The quoted statement is also nonsensical because the IFM *per se* has no ability to influence the investment decisions of the portfolio manager. The further reality is that poor performing funds do not, over time, attract assets.

We also note that the investment management market is intensely competitive already due to the number of firms and products available. The competitive drive to achieve superior performance is enhanced by the fact that most IFMs pay the same rate for trailing commissions, so competition based on dealer compensation does not, for most firms, exist. As dealers prepare for the reforms discussed in CSA Consultation Paper 33-404, this competition will intensify as dealers reduce their product lists. The nature of the Targeted Reforms discussed in that paper is such that third-party products will likely not be considered for dealer product lists without superior risk-adjusted performance and the failure of a product to be included on a dealer product list will make it impossible for such products to generate new client subscriptions, which in many cases will lead to the demise of the product. Note that one major Canadian integrated bank-owned dealer recently announced a reduction in its recommended list by 1/3 (from 49 third party funds to 33). Under the Targeted Reforms, it is unlikely that funds not on that list will be sold within that dealer's network.

Investor Ability to Negotiate Fees

The CSA states that "since the cost of dealer compensation is embedded in the fund's ongoing management fees, investors have no ability to directly negotiate this cost and consequently have no control over the amount they ultimately pay their dealer and their representative."[10] The assertion that investors in trailing commission-paying accounts have no ability to negotiate fees is littered throughout the Consultation Paper and seems to be an important factor in CSA deliberations. While it is true that such an investor cannot negotiate fees, the CSA implies that if the client were in a fee-based account, it could. This is preposterous. While we cannot say it never occurs, there is very little evidence that fee-based clients that are not considered to be high net worth investors have a real ability to negotiate fees. We do believe this happens but that such occurrences are rare and subject to exigent circumstances. Most retail investors have no ability to negotiate fees. Dealers will simply not do

[10] Consultation Paper, p.13

that. We encourage the CSA to engage specifically on this point with the heads of bank-owned IIROC dealers.

Cross-Subsidization

The CSA states "because trailing commissions are deducted at the fund level rather than the account level, some investors indirectly subsidize certain dealer compensation costs that are not attributable to their investment fund."[11] As a basic premise, any collective investment scheme involves some degree of cross-subsidization. The reason for this is that if each investor paid "a la carte" for services used, it would cost more for all and there would be a net social welfare loss. By pooling expenses, the individual pays less. For firms that charge operating expenses on a cost recovery model, there is no question that investors are better off in a pooled vehicle with cross-subsidization than investing in the identical portfolio on their own.

Notwithstanding our statement above, the CSA assertion in this instance is simply wrong. In a multiple series mutual fund, there are common expenses charged to all series and there are series specific expenses charged only to that series. The management fee is an example of the latter. The trailing commission is directly tied to the management fee. That is, the IFM determines a stripped down management fee separately from a trailing commission and then simply adds the two for the stated management fee for series that pay trailing commissions. An investor in a series designed for fee-based accounts typically pays a 1% management fee and does not at all subsidize the investor in a trailer commission-paying series that pays a 2% management fee, since the difference in the two, the dealer compensation, is only paid by the investor who pays the higher fee.

Internal Dealer Transfer Payments

The CSA states that it will specifically permit internal transfer payments from affiliates to dealers in integrated models where the payments are not directly tied to an investor's purchase or continued ownership of mutual funds.[12] We are astonished by this.

While we understand the theoretical basis for this position, we note that there is no practical way to ensure compliance with it. That is, there is no means to police the level of internal transfer payments and to demonstrate that it does not relate to distribution costs. We urge the CSA to re-think this issue. There is no reason for these payments and these payments are simply prone to abuse.

Entry of Lower Cost Providers

The CSA states that "some lower-cost mutual fund providers have expressed to the CSA the view that embedded commissions function as a barrier to market entry."[13] We are disappointed that the CSA has not provided more particulars on this point because it sounds

[11] Consultation Paper, p.13
[12] Consultation Paper, p.22
[13] Consultation Paper, p.52

like a bunch of whining and sour grapes to us. Our understanding is that Vanguard has raised this issue prior to entering the Canadian market yet their entry into the Canadian market is a success by any measure. The other unnamed companies may feel that because of the numerous competitors in our small market that it is simply not viable to compete and seek assistance from government to make it easier for them. What will the CSA say if these competitors do not come to Canada even after a ban on embedded commissions and what will the CSA say when these competitors do not have the success they envision? This is a spurious argument to be put forward by the CSA.

The CSA continues in that part of the Consultation Paper to talk about other niche providers entering the market and having success based on their performance in their home market. The CSA must be aware that these providers would be prohibited from marketing their products in Canada based on track records abroad and the CSA must be aware that Canadian dealers will not put a product on their shelf unless they know the IFM very well or until there is proven performance by way of at least a 3-year track record for the current mandate. As a result of these facts, it is not clear how the CSA concludes that niche providers will have the impact imagined as it is difficult for them to promote new products based on success outside of Canada.

<u>Clarifications of Historical Items</u>

Before discussing our proposed solution to the issues raised in the Consultation Paper, we believe it is important to provide historical context to the two forms of embedded commissions most under attack in the Consultation Paper: deferred sales charges and trailing commissions.

Clarifying Misconceptions: Deferred Sales Charges

The CSA has declared that the embedded commissions with which it is concerned are trailing commissions and DSC, both of which are paid by the IFM to the dealer. Interestingly (and inexplicably) the CSA is not concerned with other payments from the IFM to the dealer, including referral fees or internal transfer payments. In our opinion, the DSC historically served an important purpose, although we acknowledge that the original noble purpose has been so distorted that, at this time, there is more harm from permitting the DSC option than there is good. We would not object to a simple ban on the DSC.

That said, we believe it is important to recount the history of the DSC and clarify the mythology around it so that others may consider whether there is merit in continuing with the DSC.

From the IFM's perspective, the DSC was established to facilitate investment in mutual funds by small investors who, by definition, could not afford to pay much for advice yet still wanted access to professional investment advice and portfolio management. The DSC was originally designed to ensure the IFM would be indifferent between a sale under the front-end purchase option and the DSC option. At the time the DSC option was introduced, dealers were charging 5% or more for the front-end option and also receiving a 1% trailing commission from the IFM. For DSC to be viable, therefore, it was necessary to include a 5% upfront commission. In other words, instead of the client paying a 5% up front commission out of pocket, the IFM effectively loaned the 5% to the client to pay the dealer so that the client could invest all of their money, and the client agreed to repay the loan. Given the financing fees for DSC, if the IFM paid the full trailing commission for the period of the loan, then it would lose money unless the fund significantly outperformed. As such, trailing commissions were cut by half to 0.50% and the calculation went from there. The IFM also had to make an assumption about the holding period and assumed 12 years. Like any lender, they had to make some assumptions so it was assumed the fund would simply have a 0% return. This was important since there is an expected revenue stream from a loan and if the client repays the loan early, the lender does not meet revenue expectation. In a bank loan, this is called a prepayment penalty. In a DSC loan, it is called a redemption charge schedule. In both cases, the design intent is to make the lender indifferent between prepayment and a full term loan. So with the combination of the management fee growth, the half trail and the time, the loan (and IFM financing costs) are repaid over time.

This all worked nicely when commissions for sales under the front-end purchase option were regularly charged at 5% but that has not been the case for some time. As such, the declining front-end commission distorted incentives and led dealers to promote DSC over the front-end purchase option because they would get paid more. They took the view that the client does not pay for DSC, so they have more invested and are better off and they assumed that if the fund performed poorly, the investor could switch to another fund in the complex during the term of the DSC schedule. The reality is that dealers are now paid a higher commission for a purchase under the DSC option (relative to commission rates for front-end purchase option sales today). The industry has shown little inclination to modify the DSC to address this point, with newer DSC options having exacerbated the problem. Given that most sales under the front-end purchase option are done at 0%[14], there is no longer a need for DSC and, therefore, we recommend it be abolished. These considerations do not apply to trailing commissions.

Clarifying Misconceptions: Trailing Commissions

Over the last 20 years, the industry has created a fiction around trailing commissions that, unfortunately, the CSA has chosen to accept as gospel and, more recently, the Investment Funds Institute of Canada ("IFIC") has chosen to perpetuate. The fiction is that trailing commissions were designed to compensate dealers for the service and advice they provide to their clients. This is not the case. On its face, this explanation is inherently illogical as why would an IFM pay a dealer to serve the dealer's own client? In other words, why would an IFM pay a dealer to run the dealer's business?

The CSA (and now IFIC) use this fiction to then determine whether an investor is getting a "good deal" from the dealer in exchange for the trailing commission. In other words,

[14] See comment letter dated April 12, 2013 of Invesco Canada Ltd., responding to CSA Discussion Paper 81-407, p.3.

the CSA uses this fiction to determine if there is value for service and to then determine that there is not sufficient value for service.

We have previously explained in our comment letter on CSA Discussion Paper 81-407 that this is flat out incorrect. Our comment in that regard was ignored by the CSA. We were surprised that the CSA did not inquire further on this point but that requires us to largely reiterate our discussion herein.

Trailing commissions did not exist until the late 1980s and their adoption became widespread by the end of the decade or early in the 1990s. Prior to the initiation of trailing commissions, there were serious concerns relating to churning client accounts, since the dealer only was compensated on a sale of a mutual fund. At the time, dealers received as compensation for mutual fund sales, from their clients, a front-end commission of up to 10%. If the dealer chose a “good” fund for the client, the client would be expected to hold the fund for the long term and the dealer would receive no ongoing revenue stream. From a business perspective, then, the dealer would have a business with a high level of assets on its books but no way to realize revenue on those assets. That left a rather large incentive for the dealer to churn accounts (or to pick “bad funds”).

Most mutual funds are intended to be long-term investments and constant client entries and exits into and out of a fund can be detrimental to the fund and other investors therein. As such, the fund has an inherent right – some would say responsibility – to minimize the occurrence of shorter term investments. One need look no further than the 2003 market timing actions for evidence that the CSA believes that IFMs have a responsibility to ensure that their funds are not being used as short-term trading vehicles.

From the IFM’s perspective, however, it normally has assets on its books from which it derives almost all of its revenue. It is clearly detrimental to the business interests of the IFM for there to be a constant churning of investor money as that might negatively impact other investors in the fund and, ultimately, the IFM’s predictable revenue stream.

The industry thus faced a conundrum. Dealers were getting paid just for transactional activity and at a high rate (compared to today) so there was motivation to generate more revenue through more transactions. Clients paid a high rate of commission and the dealers’ solution was to find ways to pay the high rate with greater frequency. The IFMs were facing disruption to their funds, thus potentially impacting performance, but also impacting their bottom line. The common solution to this problem was trailing commissions:

> -Through a trailing commission, the dealer is able to receive a recurring and predictable revenue stream. This reduces the incentive to generate more transactions which may or may not be in the interests of their clients.
>
> -Through a trailing commission, the client gained a greater likelihood that their dealer was looking after their interests without the threat of regularly paying a large up front commission. This allowed the client to get better advice for a better price.

-Through a trailing commission, the IFM was able to prevent churning of its funds. Clients were still free to come and go based on fund performance and their own needs.

Prior to the advent of trailing commissions, therefore, the primary conflict of interest concern was churning of client accounts. While we would not anticipate churning to be an issue with the elimination of trailing commissions, we would be concerned about the flip side of that, being reverse-churning.[15] Any proposal to eliminate trailing commissions must take into account and seek to prevent such behavior or similar behaviors that market participants might devise.

<u>Our Proposed Solution</u>

As stated at the outset, Invesco Canada proposes a two-part solution to the regulatory concerns raised in the Consultation Paper: (1) prohibit the use of DSC; and (2) set (not cap) trailing commissions at 1%. We will discuss each aspect of this solution in this part.

Prohibit the Use of Deferred Sales Charges

As discussed above, the much-maligned DSC actually was conceived with the best of intentions. However, as commission structures and rates have changed over time, the DSC has not kept up. Invesco Canada currently offers the standard DSC (6-year redemption schedule, 4.9% commission paid to the dealer on purchase), Low Load 4 (4-year redemption schedule, 4% commission paid to the dealer on purchase), and Lower Load (2-year redemption schedule, 1% commission paid to the dealer on purchase). In our comment letter on Discussion Paper 81-407, we stated that 94% of our sales under the sales charge option (i.e. front-end commission paid by the client) are at 0% commission. To the extent a dealer might offer the DSC option, there is a conflict of interest that possibly, but unlikely, could be overcome with improved disclosure. However, we are skeptical of disclosure as a remedy for conflicts of interest, as demonstrated by the CSA in the Consultation Paper and in Consultation Paper 33-404, and we believe abolishment is the better approach.

We note that the most important legitimate use of DSC today is for new, small investors. Given the amounts these investors have to invest it would appear to be in their interest to invest the full amount without deductions and it is difficult, if not impossible, to devise a direct payment model that meets their needs and the dealer's revenue and profit needs. We do not believe dealers will offer such clients 0% front-end option as the dealers would lose money on those accounts. But we are also troubled by the notion that such clients should pay, indirectly, 5% (in addition to trailer commissions) to have their money invested in a low interest rate, low return environment and also pay ongoing fees. Some of our competitors

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[15] This echoes the point made in The Brondesbury Report, commissioned by the CSA following CSA Discussion Paper 81-407. Therein, the point was that there has been insufficient research on fee-based payment models to understand what conflicts of interest arise under that model and it would be ill-advised, in their view, to move to such a model without examining the conflicts present under such model. See Weinstein, E. (the Brondesbury Group), *Mutual Fund Fee Research*, prepared for Ontario Securities Commission on behalf of the Canadian Securities Administrators, Spring 2015, p.21.

have already stopped offering DSC and we have heard of no ill effects as a result. We recommend, however, that prior to proceeding with such a ban, the CSA meet specifically with firms whose business models depend on DSC. Notwithstanding the CSA's data presented in the Consultation Paper, there are a number of MFDA-licensed firms who cater to the mass market by relying on DSC. Those businesses would not be viable without DSC given the size of the accounts and the client's ability, or willingness, to pay. The CSA solution appears to be that those clients can go to bank branches or robo-advisors. However, the CSA owes it to the registrants most impacted to truly understand the business model and why it may or may not be in the public interest. If the CSA finds that it is in the public interest to offer DSC after meeting with those firms, then the CSA should obviously not prohibit the use of DSC but should consider rules around its application including, without limitation, requiring the IFM to include DSC use in its business plan filed as part of its registration application and to only approve such aspect of the business plan if issues relating to abuse are properly addressed. To be clear, we are not calling for a roundtable discussion open to all, we believe that in these circumstances a group of CSA staff (including representation from multiple provinces) should meet separately with firms whose business model is built on DSC sales to better understand the issues. We believe that a solution where such clients can agree to a commission on the transaction (which would presumably be at least 5% as the dealer requires a certain amount of revenue to make an account profitable for it), whether or not that payment is funded by the IFM in exchange for a DSC schedule, would largely mitigate the potential problem a DSC ban creates for these investors. In this scenario, having an agreement between the client and dealer setting the commission rate would be vital. In that model, we would not be averse to a ban on trailing commissions.

Setting (Not Capping) Trailing Commission Rates at 1%

Invesco Canada has previously proposed, in writing to the CSA and in in-person meetings with the senior leadership of the OSC, a cap on trailing commissions in response to the conflict of interest concerns relating to trailing commissions. While this option has been dismissed by the CSA in the Consultation Paper, in our opinion the reasons provided by the CSA demonstrate a misunderstanding of trailing commissions as well as the essence and reasons for our proposal. As such, we reiterate that proposal here.

In the past we have suggested a cap on trail on the basis that IFMs that pay an above-standard rate of trailing commission do so to garner additional flows: in other words, the very essence of one of the conflicts of interest the Consultation Paper seeks to address. The CSA solution is to effectively require a 0% trailing commission, but the reason the 0% trailing commission works is that every IFM pays the same rate. Similarly, if every IFM that paid trailing commission paid 1%, there would be no conflict among funds. Accordingly, we recommend that the CSA enact or recommend to the provincial legislatures to enact a rule or law that only permits trailing commissions on specific series designated for that method of payment (i.e. Series A) and that such trailing commissions be in the amount of 1%. Under this proposal, trailing commissions on series of securities not designated in accordance with the rule would be prohibited as would trailing commissions of less than 1%. In addition, while not vital to this proposal but perhaps more important, we recommend that there be a positive obligation on dealers to enter into a specific agreement regarding fees with their clients while allowing for multiple methods of payment, in which case, it should not matter what rate of trailing commission is set by regulation. (Note that this is also an alternative proposal to address the issues raised in the Consultation Paper.) For example, there is no policy rationale that would prohibit a client and dealer from agreeing to an account level fee of 1.50% of assets with part of that fee collected in the form of trailing commissions; in other words, the trailing commission acts to reduce that direct payment. We believe it is important to separate the fee from the method of payment so as to eliminate the confusion or lack of clarity cited by the CSA. We select 1% for this purpose as this is the standard used by the vast majority of IFMs, which would ensure the most seamless transition for back offices.

Our recommendation addresses several issues. First, competition among mutual funds based on trailing commission rates would be eliminated. Second, standardized series designations would assist in reducing client confusion over the alphabet soup of series, which is a significant contributor to the complexity issue, and it would make it clear which series are associated with which fee options. Third, a standardized trailing commission would eliminate any bias in favour of higher trailer commission-paying products (i.e. equities) over lower trailing commission-paying products (i.e. fixed income).

In light of the foregoing, we turn to the shortcomings identified by the CSA in its discussion of capping trailing commissions on page 138 of the Consultation Paper and we comment specifically on each of those:

- *as the payment of embedded commissions will continue to be permitted, they may continue to create a barrier to entry that may reduce the likelihood of lower-cost providers entering the market;*

The CSA evidence of this is scant and not convincing. In the last several years Vanguard, among others, has entered the Canadian market and appears to have done so successfully. It is disappointing that the CSA makes this assertion with no evidence, anecdotal or otherwise. It is very easy for a non-Canadian firm to tell the CSA (presumably in response to a direct question) that they are not entering the Canadian market because of barriers caused by trailing commissions, but such an excuse rings hollow. First, there is no impediment to those firms offering one or both of a trailing commission and non-trailing commission paying series. As such, the cost of additional series (which is insignificant) cannot be a realistic barrier to entry. Second, the reason many do not enter the Canadian market is because the market is not all that large or, beyond the higher net worth segment, not very profitable. Canada's population is 35 million people and is dominated by the banks. Of the 35 million people, maybe 10 million are potential mutual fund investors (and that is being generous). There are well over 100 firms offering mutual funds or ETFs (or both) to the investing public, including iShares and Vanguard, both of whom are known for ultra-low fees on their core products. No other low cost provider comes close in terms of name recognition to these two firms which leads one to conclude that the notion that other low cost providers can come into this market and have an impact is pure fantasy.

• the presence of embedded commissions may continue to make the fee structure more complex, which may continue to inhibit investors' understanding of such costs;

We find this concern confusing. In a fee-based series of units, the fee is pretty simple: management fee as disclosed in the prospectus is paid by the fund, operating expenses or fixed rate administration fee is charged to the fund, the client directly pays the dealer for advice. In other words, there are 3 components. In an embedded commission series of units, the fee is equally simple: management fee as disclosed in the prospectus is paid by the fund, operating expenses or fixed rate administration fee is charged to the fund, the IFM pays the dealer for advice to the client (notwithstanding our comments that the trailing commission was not created for the purposes of paying for advice). Again, there are only 3 components. If this is set out graphically for the client, it would be quite simple to see, for commission-based accounts, how much of the management fee is a true management fee and how much is trailing commission and compare that to a similar chart for fee-based (showing the management fee and the advice fee separately). It would actually be a simple matter to personalize this for the client based on their historical activity and come to a decision as to which model is better for that client. Such an analysis would show that some clients should not switch to fee-based accounts because, for them, it as a bad deal. The point, however, is that fee structures are not complex. What might make this more complex is the numerous purchase options including front-end, DSC with a 6-year schedule, DSC with a 4-year schedule, DSC with a 2-year schedule, and a US dollar option. This is confusing but has little to do with embedded commissions. The solution to this particular confusion is quite simple: prohibit the DSC model and then the only real option is to decide (a) commission-based versus fee-based and (b) U.S. dollars where offered versus Canadian dollars. This is pretty simple.

• embedded commissions will still remain a "one-size-fits-all" fee that may not align well with the services and advice actually provided to individual investors in accordance with their specific needs, expectations and preferences; and

We address this is in our earlier comments regarding the origination of trailing commissions. That said, there is no reason for embedded commissions to be a one-size-fits-all fee. As discussed earlier, the CSA is confusing the concept of the negotiated or agreed upon fee with the method of paying the fee. There is nothing in securities regulation that prevents dealers from adopting a hybrid model. That the CSA has not encouraged this is mildly surprising since there would be no better way to ensure transparency of trailing commissions if the dealer was required to enter into a fee agreement with clients in all circumstances, even if the full fee is satisfied by the trailer. Adopting such a requirement would also present the opportunity to properly characterize and clarify the relationship between and among the client, dealer and dealer representative.

• to the extent DSC options are reduced or eliminated, this approach would tend to place firms that rely on these options (e.g. independent investment fund managers and dealers) at a disadvantage relative to those that do not (e.g. integrated investment fund managers and dealers).

We do not understand this argument. The effect of the proposals contained in the Consultation Paper is to eliminate DSC options altogether which would have the effect cited in this bullet point. It is not clear how capping trailing commissions makes that worse.

The analysis above directly contradicts the CSA conclusions under the heading "Why the CSA is not pursuing a fee cap." The CSA notes a "non-traditional role" of setting fee caps. This is incorrect. The CSA already sets certain trading fees[16]. The real issue is whether the CSA has the authority to set trailing commission fee caps. We believe that Ontario, for example, has the authority do so under s.143(1)32.ix of the *Securities Act* (Ontario). In the alternative, implementation would require a legislative amendment. We note that much of NI 31-103 could only be implemented in Ontario with legislative amendments. We see the same in other provinces on a regular basis, and we do not believe that such is any impediment to reform. On the contrary, we believe this is an appropriate case for legislative involvement as the changes being proposed are radical and fundamental. Changes that have such an effect are not the purview of the administrative system but properly belong in the legislative system. The administrative system was designed to allow a specialized regulator with intimate knowledge of the issues to react rapidly to events under certain circumstances. Such conditions do not apply in the current context given that this debate has been ongoing for 20 years, i.e. there is no essential requirement for rapidity. Further, if a change such as that contemplated is going to be made, legislators answerable to their constituents should be the ones to make those decisions rather than faceless, nameless bureaucrats to whom the public has no recourse whatsoever.

Unintended Consequences

We will conclude this letter by addressing the consequences of the CSA proposal. There is no doubt that this proposal will be incredibly disruptive. That is clearly its intent. It will force some dealers and some IFMs out of business. We dispute that this will lead to new entrants to replace the firms who exit as there is simply no evidence that such will or is likely to occur. It is likely that this proposal will lead to dealer consolidation and we urge the CSA to consider the consequences of that. Where there are fewer dealers, does the CSA truly believe that will lead to an environment where individual investors have greater power to negotiate fees? The history of economics suggests the opposite result. Regardless, the CSA does seem to believe that the outcome of a ban on embedded commissions will be to reduce fees. These assertions are littered throughout the second half of the Consultation Paper and are the only major assertions not footnoted. Without substantiation, they appear to be merely Staff speculation dressed up as legitimate economic theory. If the CSA is wrong about these outcomes, the consequences will be devastating to some, yet for no purpose. We do not believe that regulators have an inherent moral right to do devise policy based on wild speculation. Regulators are allowed to be wrong in devising policy but only if there is a reasonable basis for their belief that the policy change will remedy a particular situation. The Consultation Paper aims to provide such a basis but it fails under the weight of its own (lack of) logic. The most important conclusions and predictions are made with no substantiation

[16] See National Instrument 23-101 *Trading Rules,* and Press Release dated January 26, 2017, "Canadian Securities Regulators to Lower Trading Fee Cap for Non-Inter-listed Securities" issued by the CSA.

whatsoever. If the CSA is incorrect, as we believe it is, and it proceeds with this reform, then the result of this proposal will be a deterioration of, rather than an improvement in, the status quo. In light of this, the CSA should have the courage to test the conclusions it reaches in the Consultation Paper. In that regard, the CSA should solicit feedback from independent reputable economists and think-tanks, including the C.D. Howe Institute, the Fraser Institute and others. Finding an obscure academic to support CSA conclusions will offer no comfort to the public and it will erode the CSA's reputation even further in the eyes of the public.

Others have commented extensively on the unintended consequences of the proposals contained in the Consultation Paper, including the potential for an "advice gap". We will not comment on those as we have little to add to that discussion and we are not convinced that the consequences are in fact unintended. We will, however, comment on two impacts.

First, it is clear from this Consultation Paper, CSA Consultation Paper 33-404, and public statements of senior leadership of the OSC that they disagree with the concept of active management for retail investors. With respect, there are many flaws with this view[17] and, obviously, a firm such as ours has no choice but to disagree with it. But that is not, in our view, a proper debate for a regulator to initiate or in which to engage. If the ultimate goal is to ban or dissuade investors from investing with active managers as the recent initiatives suggest, this is clearly outside the scope of a securities regulator and should be referred to the legislatures.

Second, and more important, there is little doubt that this and the other initiatives referred to above will benefit bank-owned wealth management firms at the expense of non-bank-owned firms and the CSA acknowledges this.[18] Aside from the fact that it is fundamentally wrong for a regulator to actively favor one group of registrants over another, the favored group of registrants – the banks – have been in the news lately for alleged unethical behavior toward their clients.[19] These alleged acts include placing clients in unsuitable mutual funds simply because that will help the bank meet earnings targets.[20] To date, there has been virtually no reaction to these stories from the CSA and the only governmental response has been through a federal parliamentary committee. These allegations have been levelled at some of these dealers by their own employees. The CSA acknowledges that an advice gap would be created by banning embedded commissions[21] and it believes that issue is mitigated through bank branches and digital offerings. That one of those mitigation strategies has now been called into question in a public manner, the CSA must re-think how it intends to deal with an advice gap.

[17] We have discussed this privately with the OSC and do not believe a full discussion of this issue in this letter is helpful.
[18] Consultation Paper, p.70, "...we would anticipate that both the discontinuation of embedded commissions and the potential KYP reforms proposed in CP 33-404 would be unlikely to reverse, and may even increase, the trend toward retaining mid-market and affluent households within the branch network."
[19] http://www.cbc.ca/news/business/banks-upselling-go-public-1.4023575
[20] http://www.cbc.ca/news/business/td-bank-employees-admit-to-breaking-law-1.4016569
[21] Consultation Paper, pp.62-63.

Thank you for providing us with the opportunity to comment on this important initiative. We would be pleased to discuss our comments further should you so desire.

Yours very truly,

Invesco Canada Ltd.

Eric Adelson
Senior Vice President and Head of Legal – Canada

APPENDIX

SUMMARY OF CONSULTATION QUESTIONS

Part 2

1. Do you agree with the issues described in this Part? Why or why not?

   No, for the reasons set forth in the main part of our letter.

2. Are there other significant issues or harms related to embedded commissions? Please provide data to support your argument where possible.

   We are not aware of any issues or harms that were not raised in the Consultation Paper.

3. Are there significant benefits to embedded commissions such as access to advice, efficiency and cost effectiveness of business models, and heightened competition that may outweigh the issues or harms of embedded commissions in some or all circumstances? Please provide data to support your argument where possible.

   To respond to this question requires us to accept the premise regarding harms, which we do not. We have set forth the benefits of embedded commissions in our letter.

Part 3

4. For each of the following investment products, whether sold under a prospectus or in the exempt market under a prospectus exemption:

   - mutual fund
   - non-redeemable investment fund
   - structured note

   should the product be subject to the discontinuation of embedded commissions? If not:

   a. What would be the policy rationale for excluding it?
   b. What would be the risk of regulatory arbitrage occurring in the exempt market if embedded commissions were discontinued for the product only when sold under prospectus?

   In no cases should the ban apply. As we have set out in the letter, there are proper and improper uses of embedded commissions. We can see no rationale to ban for some products but not for others or based on method of distribution. If the CSA is not convinced that this initiative will not achieve the results it sets out to achieve, then being selective among products or distribution method would considerably worsen matters. If embedded commissions were permitted only in the exempt market, we

would expect a massive shift toward the exempt market. It is very easy to offer products at retail via offering memorandum in most provinces and that is simply what would occur.

5. Are there specific types of mutual funds, non-redeemable investment funds or structured notes that should not be subject to the discontinuation of embedded commissions? Why?

   As stated in our previous responses, this should be an all or nothing proposition.

6. Are there other types of investment products that should be subject to the discontinuation of embedded commissions? Why?

   As we have stated, if embedded commissions are discontinued for one product, they should be discontinued for all products.

7. Do you agree with the discontinuation of all payments made by persons or companies other than the investor in connection with the purchase or continued ownership of an investment fund security or structured note? Why or why not?

   We do not, as set forth in our letter. However, the Consultation Paper is not proposing a discontinuation of all payments. If all possible payments were prohibited, including various payments permitted under NI 81-105, the proposal would be strengthened significantly and would be more likely achieve its intended outcomes.

8. Are there other fees or payments that we should consider discontinuing in connection with the purchase or continued ownership of an investment fund security or structured note, including:

   a. the payment of money and the provision of non-monetary benefits by investment fund managers to dealers and representatives in connection with marketing and educational practices under Part 5 of NI 81-105;

   b. referral fees; and

   c. underwriting commissions

   Why? What is the risk and magnitude of regulatory arbitrage through these types of fees and commissions?

   There is no good reason why (a) and (b) above should be permitted to continue if the concern with embedded commissions is that payments by IFMs to dealers causes conflicts. Underwriting commissions are a different category altogether and have nothing to do with investment products. For corporate finance offerings to work, there has to be independent due diligence and that must be paid for. That is the purpose of (c). Whether or not that is an effective model is a different issue and outside the scope of the issues raised in the Consultation Paper.

9. If payments and non-monetary benefits to dealers and representatives for marketing and educational practices under Part 5 of NI 81-105 are maintained further to the discontinuation of embedded commissions, should we change the scope of those payments and benefits in any way? If so, why?

   Please see our previous answers on this topic.

10. With respect to internal transfer payments:

    a. How effective is NI 81-105 in regulating payments within integrated financial service providers such that there is a level playing field for proprietary funds and third party funds?

    b. Should internal transfer payments to dealers within integrated financial service providers that are tied to an investor's purchase or continued ownership of an investment fund security or structured note be discontinued? Why or why not? To what extent do integrated financial service providers directly or indirectly provide internal transfer payments to their affiliated dealers and their representatives to incent the distribution of their products?

    c. Are there types of internal transfer payments that are not tied to an investor's purchase or continued ownership of an investment fund security or structured note that should be discontinued?

    a. NI 81-105 has been completely ineffective in this regard. Please see our comment letter on CSA Consultation Paper 33-404 for a partial list of nefarious practices engaged in by integrated firms to promote their own product as well as CSA Staff Notice 33-318 on compensation practices. One need look no further than the proliferation of integrated firms over the past 10-15 years and the reduction in independent firms for evidence of the ineffectiveness of NI 81-105 in this regard.

    b. These payments should be subject to regulation. For multinational firms, there are legitimate transfer pricing issues that must be addressed for international tax purposes. However, for domestic firms, there is not. Typically results are consolidated at a parent entity and, as such, whether the IFM or the dealer receives the revenue should not be relevant.

    c. We are not aware of any. More importantly, if some payments are tied to distribution and some are not, and the former are banned but not the latter, we are highly confident that the quantum of the latter will increase significantly. In other words, internal transfer payments are highly capable of manipulation absent tough regulatory scrutiny and there is no evidence that the CSA is capable of such scrutiny in this particular circumstance.

11. If we were to discontinue embedded commissions, please comment on whether we should allow investment fund managers or structured note issuers to facilitate investors'

payment of dealer compensation by collecting it from the investor's investment and remitting it to the dealer on the investor's behalf.

In this scenario, the client would have to enter into an agreement with the dealer regarding compensation and method of payment. Allowing this is consistent with the proposed ban on embedded commissions and should be permitted.

Part 4

Addressing the issues

12. Based on a consideration of the data and evidence provided in this Part, would a proposal to discontinue embedded commissions address the three key investor protection and market efficiency issues discussed in Part 2?

    Given how the CSA has chosen to phrase the three issues, the answer to this intellectually dishonest question is obviously 'yes'. However, for those who disagree with the phrasing used, the answer is 'no'.

13. Are there other ways in which the CSA could address these issues that could be introduced in conjunction with, or separate from, the discontinuation of embedded commissions?

    In our letter, we have proposed an alternative that addresses all of these issues in a less disruptive manner.

14. Are there other conflicts of interest that could emerge following a transition to direct pay arrangements that would not be addressed in the current securities regulation framework?

    The primary issue that will emerge is reverse-churning or, put colloquially, the phenomenon of "set it and forget it." We are concerned that clients will be left in products for too long. A secondary issue arises if the mass market is stuck dealing with banks or digital offerings as their only options.

Change in investor experience and outcomes

15. What effect do you think the removal of embedded commissions will have on investor experience and outcomes? In particular:

    - Will investors receive advice and financial services that are more aligned with the fees they pay?
    - What effect will the proposal have on the growth of automated advice? Is this likely to be beneficial to investors?

- Is discretionary advice likely to increase in Canada as we have seen in the other markets that have transitioned away from embedded commissions and, if so, would this shift be positive or negative for investors?
- What effect will the proposal have on the growth of the online/discount brokerage channel and cost of fund products offered in this channel? Is this likely to be beneficial to investors?
- What effect will the proposal have on the cost and scope of advice provided to specific investor segments?

We decline to respond as we believe we have answered these questions in our comment letter. In our view, this question makes obvious the regulatory intent and we remind the CSA that we do not think this type of change is appropriate for a regulatory body to make. This magnitude of change and the underlying goals – while laudable – are the proper purview of an elected legislature in a democracy. That the OSC, for example, is answerable to the Minister of Finance is little protection given the structures of government and how accountability works in practice.

16. What types of payment arrangements are likely to result if this proposal is adopted? In particular:

- Would the payment arrangements offered by dealers to investors differ based on investor segment? If so, how and why?

While the CSA believes that this proposal will lead to a wide range of payment arrangements, we believe that it is naïve to assume that anything other than asset-based fees will dominate. There is simply no evidence that dealers will be satisfied with other fee structures as a general matter.

17. Do you think this proposal will lead to an advice gap? In particular:

- Which segments of the market are likely to be affected? Please consider segmentation by wealth, geography (size and location of community e.g. remote, small, medium, large), age, technological sophistication, the level of fund ownership across households, etc.
- Do you agree with our definition of an advice gap?
- Should we differentiate between an advice gap for face-to-face advice and an advice gap generally?
- What types of advice or services currently provided today would be most affected by the proposal?
- Are there any potential interactions between this proposal, existing reforms such as CRM2 and other potential reforms such as CSA CP 33-404 that may affect the size of any potential advice gap?

- How could a potential advice gap, face-to-face advice gap or financial service gap be mitigated?
- Do you think that online advice could mitigate an advice gap? If so, how?
- Do you think that the significant market share of deposit-taker owned and insurer-owned dealers in fund distribution in Canada will affect the size or likelihood of an advice gap to develop?

It is clear that an advice gap will develop; the CSA confirms this in the Consultation Paper itself.

Industry change independent of regulatory response to discontinue embedded commissions

18. Given some of the changes we have seen in the industry over the past few years (fee reductions, introduction of DIY series, streamlining of fund series, automatic fee reductions increasing access to fee-based options etc.), what is the likelihood that the fund industry will transition away from embedded commissions without regulatory action? In particular:

- Will the industry continue to transition away from embedded commissions if the CSA does not move forward with the proposal?

As set out in our letter, we believe that the industry will continue to transition toward fee-based accounts as it is in the economic interest of dealers to do so.

19. How accurate is Figure 8 regarding the purchase options available to fund investors by channel, account size and firm type? In particular:

- Do you see payment options and business models evolving at present?
- How are they likely to change over time if the CSA were to choose not to move forward with the proposal?

We have no comment on Figure 8.

20. We note that the distribution of fee-based series is still relatively limited in Canada versus other markets. Are there obstacles (structural, operational, regulatory, investor demand, etc.) specific to Canada limiting the use of fee-based series by dealers?

To respond to this question, we revert to our response to Q.18 and the contents of our letter in which we clearly explain why dealers prefer accounts to be fee-based rather than commission-based. Fee-based accounts are not new, yet dealers have had difficulty convincing clients to move to such accounts. In our view, this is for good reason. Not every client agrees with the CSA that there should be a full blown financial planning relationship, which is the best scenario for fee-based accounts. Some investors, especially those who do not trade frequently, rightly prefer commission-based accounts as it is a better financial deal for them. There is nothing in securities

regulations that permits dealers to serve those accounts less than fee-based accounts. Accordingly, clients tend to choose the option that results in the lowest fee to them.

Potential impact on competition and market structure

21. Please describe how discontinuing embedded commissions will affect competition and market structure and whether you agree with the analysis set out in Part 4? In particular:

- Do you think the proposal will have an impact on the level of industry consolidation or integration? What about with respect to the concentration of mass-market investor assets held in investment products managed by deposit-taker owned firms?
- What are the likely impacts on investor outcomes and market efficiency of any potential consolidation?
- What opportunities and what challenges do you think the proposal would introduce for specific industry stakeholder groups?
  - Independent dealers?
  - Independent fund manufacturers?
  - Integrated financial service providers?
  - Mutual fund dealers?
  - IIROC dealers?
  - Online/discount brokers?
- What is the likelihood and magnitude of regulatory arbitrage across similar financial products such as segregated funds and deposit-taker products?
- What would be the impact on dually-licensed mutual fund dealers and insurance agents?
- Will the proposal lead new, lower-cost entrants to the market? Why and how?
- Does the interaction between this proposal and the proposals set out in CSA CP 33-404 change your responses to the questions above and, if so, how?
- Will a transition away from embedded commissions reduce fund series and fee complexity, as we have contemplated?
- Do integrated financial service providers have an advantage in terms of their ability to cross-sell and cross-subsidize across business lines? If so, how?
- What are the potential effects on competition of the rise in online advice? Are these effects likely to be large and positive?

The bullet points in this question assume outcomes that have no basis in reality or economics. Therefore, we cannot properly respond.

22. What impact will the proposal have on back office service processes at the investment fund manager or at the fund dealer? In particular:

- Is there any specific operational or technological impact that we should take into consideration?

  Eliminating embedded commissions should have no meaningful adverse impact to the back office of an IFM.

23. The payment of embedded commissions requires the dealer and the investment fund manager to implement controls and oversight (with associated compliance costs) in order to mitigate the inherent conflicts of interest today.

- Would the transition to direct pay arrangements alleviate the need for some of these controls and oversight?
- To what extent, if any, does the use of direct pay arrangements by representatives today (e.g. when a representative provides services under a fee-based arrangement) alleviate the need for some of these controls and oversight?

  It is certainly possible that an IFM would be able to eliminate some controls and oversight. For firms that operate with a cost recovery model, we would expect that to have an impact on chargeable fund expenses although we would not expect such impact to be material. For firms operating on a fixed rate administration fee, the elimination of these controls and oversight directly improves the IFM's bottom line. As such, a potential impact of this proposal is a financial benefit to firms that charge a fixed rate administration fee. In our view, firms that operate in this manner tend to derive profit from this activity and we question the validity of such. We note that securities regulators let this practice develop and did not impose necessary oversight conditions to ensure fixed rate administration fees do not become a profit centre. We are heartened that at least in a small number of cases, the independent review committee of funds that adopted fixed rate administration fees imposed conditions to ensure this does not become a profit centre but we note that very few IRCs have done so and we do question why it is that securities regulators do not apparently consider this to be an important conflict of interest.

24 Embedded commissions, especially trailing commissions, provide a steady source of revenue for dealers and their representatives. If embedded commissions were discontinued, would dealers be able to compensate for the loss of this revenue with direct pay arrangements?

As we have shown in our letter, dealers are financially better off with direct pay arrangements.

25. Aside from commission grids and salaries, what other approaches to representative compensation might dealers use if we were to discontinue embedded commissions? How are these approaches likely to change over time?

CSA Staff Notice 33-318 sets out many practices that are not commission grids and salaries. While such notice was prepared by the OSC's Compliance and Registrant

Regulation Branch and the equivalent at other securities regulators and the Consultation Paper was prepared by the OSC's Investment Funds and Structured Products Branch and the equivalent at other securities regulators, we would expect the latter to be well informed on this matter and read the former's staff notices.

26. What impact will the proposal have on representatives in the industry? In particular, what impact will the proposal have on the:
    - career path;
    - attractiveness of the job;
    - typical profile of individuals attracted to the career;
    - recruitment; and
    - relative attractiveness of careers in competing financial service business lines?

    We defer to dealing representatives to respond to this question.

Part 5

27. How practicable are the mitigation measures discussed and how effective would these measures be at assuring:
    - access to advice for investors,
    - choice of payment arrangements for all investor segments, and
    - a level playing field amongst competing investment products?

    We believe that elements of these measures are naïve. For example, one mitigation strategy is to let IFM's collect the fee for the investor and remit it to the dealer. That is, the dealer and investor enter into a fee agreement but instead of the investor remitting the fee directly, the IFM collects it from the investor's account and remits it to the dealer on the investor's behalf. Invesco Canada has offered this service for several years. Typically, IIROC firms have no interest in this service since they have invested in the infrastructure to offer fee-based accounts and have no need for this service. However, MFDA firms typically do not offer fee-based accounts due to lack of infrastructure, which is why we (and others) offered this service. We have not found there to be significant take up of this service and as such, we question how effective a mitigation strategy this might be. Note that not all IFMs offer this service and unless widely adopted, MFDA firms may feel they are only able to deal with IFMs who do offer the service, even if the product assessments they make as part of their shelf decisions might suggest different results.

28. What other measures should the CSA consider to mitigate the above unintended consequences?

    The CSA should try to open its mind and not pre-determine the outcome of consultations. The public statements of the Chair of the OSC, beginning with the CBC interview on January 10, 2017, make clear that the CSA has determined the outcome of this consultation.

29. Other than the potential impacts we have identified in Part 4, what other potential unintended consequences, including operational impacts and tax consequences, may arise for fund industry stakeholders and investors further to the discontinuation of embedded commissions? In particular:

- Would there be a negative tax impact to investors associated with their payment of dealer compensation under direct pay arrangements? In particular, would the investor's payment of dealer compensation through periodic fund redemptions facilitated by the investment fund manager attract tax consequences? Please explain.
- To the extent a transition to direct pay arrangements results in the rationalization of fund series, could this rationalization attract negative tax consequences for investors?
- What, if any, measures, regulatory or otherwise, could assist in mitigating potential operational and tax impacts?

It is difficult to assess the tax impacts as the federal government has made tax changes affecting mutual fund investors in every budget under the current Prime Minister. None of these changes have been telegraphed and, in some cases, we would expect the transition to give rise to a taxable event.

30. With respect to the loss of a form of cross-subsidy from high net worth investors to lower-wealth investors in a fund further to a transition to direct pay arrangements,

- to what extent (please quantify where possible) would the loss of this cross-subsidy increase the cost of providing advice and services to lower-wealth fund investors under direct pay arrangements?;
- does the existence of this form of cross-subsidy suggest that high net worth fund investors may be indirectly paying fees that are not aligned with the services they are receiving (i.e. do the fees they pay exceed the actual cost of the services and advice they receive?); and
- what measures may mitigate the potential effects on dealers, representatives and investors from the loss of the cross-subsidy?

We reject the premise of this question, as discussed in our letter.

31. What measures could fund industry participants proactively take to mitigate the unintended consequences that may stem from the discontinuation of embedded commissions?

We do not wish to respond to this question as such response would necessarily divulge competitively sensitive information.

32. For each transition option, please tell us how your business (investment fund manager or dealer) would have to operationally change or restructure in terms of systems and processes and the related cost implications. Where possible, please provide data on the estimated costs.

- Are there unique costs or challenges to specific businesses?
- What transition period would be appropriate?
- Should existing redemption schedules for DSC and low-load purchase options be maintained until the redemption schedule is completed, or discontinued at the Transition Date?

We do not wish to respond to this question as such response would necessarily divulge competitively sensitive information.

33. Which transition option would you prefer? Why? Are there alternative transition options that we should consider?

While we have no preference – neither option would benefit us as an IFM over the other option – our primary concern with any transition relates to DSC schedules still in force. Some have suggested that on transition, any redemption charge would be waived. We vigorously oppose that. Any DSC is subject to financing and is a multiparty arrangement. It would be commercially unfair to waive redemption charges where a DSC schedule is still in effect. This could cause immense hardship for IFMs based solely on the amount of DSC they have outstanding. We would expect that, overall, the hardship that this would impose would provide IFMs with an incredibly strong incentive to challenge this proposal in the courts and further delay implementation.

34. As discussed in Appendix B, the CSA did not retain the option of capping embedded commissions, either as a stand-alone solution to the key issues discussed in Part 2 or as an interim step toward an eventual discontinuation of embedded commissions. Should the CSA further consider using a fee cap as a transition measure? Why?

Please see the proposal in our letter for a full response to this question.

<u>Part 6</u>

35. Please explain whether you think each of the initiatives discussed above will, either alone or in combination:

    - address the three investor protection and market efficiency issues and their sub-issues identified in Part 2; and
    - address or not address any additional harms or issues that you have identified.

We decline to respond to this question.

36. Are there alternative options or measures, whether regulatory or market-led, that could successfully address the three investor protection and market efficiency issues and their sub-issues identified in Part 2. If so, please explain.

Please refer to our letter.