Borden Ladner Gervais LLP
Bay Adelaide Centre, East Tower
22 Adelaide Street West
Toronto, ON, Canada M5H 4E3
T 416.367.6000
F 416.367.6749
blg.com

Borden Ladner Gervais

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Delivered by Email

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 Territory
Superintendent of Securities, Nunavut

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, 22nd etage
C.P. 246, tour de la Bourse
Montreal, Québec
H4Z 1G3
consultation-en-cours@lautorite.qc.ca

Dear Sirs/Mesdames:

Re: CSA Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions* - Comments of the Investment Management and Securities Litigation Groups of Borden Ladner Gervais LLP

We are lawyers in the Investment Management and Securities Litigation practice groups of Borden Ladner Gervais LLP and are writing this letter to the Canadian Securities Administrators to provide our collective comments on the above-noted Consultation Paper. We provided our comments to the CSA on the CSA's December 2012 Discussion Paper on mutual fund fees, as we have done on virtually every consultation and rule proposal that has affected the investment fund and asset management industry for the past 20+ years.

BLG has been privileged to work with many managers of mutual funds and other investment funds operating in Canada and internationally for over 50 years. We have assisted in the structuring and establishment of hundreds, if not thousands, of mutual funds, and other types of investment funds. As such, we have seen first-hand the huge growth in the investment funds industry – not only in terms of its increased importance for investors, but also the heightened sophistication of strategies, features and services associated with the various funds. We have also seen the significant rise in regulation and regulatory focus on investment funds. We often assist in industry initiatives, including those organized by The Investment Funds Institute of Canada (IFIC), the Portfolio Management Association of Canada (PMAC), and the Investment Industry Association of Canada (IIAC). Our lawyers participated in the working group that formulated IFIC's comment letter on the Consultation Paper, as we did with the 2012 Discussion Paper.

We have also been privileged to work with many registered dealers (members of the MFDA and members of IIROC) and with many advisors, and understand their business models and successes, as well as the pressures (regulatory and operational) facing them in their work with Canadian investors to assist those investors to meet their financial objectives.

We considered both the 2012 Discussion Paper and this Consultation Paper with interest and commend the CSA for their thoughtful review of the policy issues the CSA see with the current fee structuring models – and for their significant attempts to back up their positions with evidence and research, particularly with this Consultation Paper. It is clear that much thought, resources, research and analysis have gone into this Consultation Paper and for this reason we wish to clarify that, although we do not agree with the CSA's proposals (for the reasons we outline below), we do recognize the CSA's extensive efforts and the importance of the issues raised in this Consultation Paper for investors – and also for the financial services industry.

It is in this spirit and with this background that we provide the CSA with our collective comments and thoughts on the Consultation Paper. Our comments should not be taken as the views of BLG, other lawyers at BLG or our clients.

Fundamentally our comments on the Consultation Paper have not materially changed from our earlier comments on the December 2012 Discussion Paper. We do not consider that the CSA have made a case for banning "embedded commissions" and we consider that the propositions put forward in the Consultation Paper may do more harm than good not only to investors, but also to participants in the Canadian asset management industry. In our view, the CSA's conclusion that banning embedded commissions, and requiring the industry to adopt other fee models, will have an overall positive, better result for investors, is ultimately unsupported by 'hard' evidence.

In addition, we urge the CSA to:

1. Consider the implications of the proposals put forward in the Consultation Paper on all facets of the industry – as we discuss below, the CSA has not considered important elements of the asset management industry or SRO regulation, as it relates to the overall fees discussion, which we consider problematic.

2. Consider carefully all comments received on the Consultation Paper, notwithstanding those comments may not raise "new arguments" or may not be "fact" or may not be supported by evidence. The onus should not be on the

industry to refute CSA opinions and views with "evidence" – the industry's views and opinions based on participants' own extensive experience with the needs and preferences of investors, provided by way of commentary on the Consultation Paper should be considered just as carefully as the CSA considers its own views and opinions.

3. Carefully tie together all of the regulatory initiatives undertaken over the past 10 years into a holistic package – with a unifying message and clear coherent regulatory goals and principles, along with a more creative, less prescriptive approach to regulating the industry. We provide more commentary on this below.

Our comments on the Consultation Paper follow (each of which elaborates on the above-noted fundamental comments).

1. Commentary on the Overall Underlying Premises of the Consultation Paper

Underlying the Consultation Paper is the deeply held assumption (and regulatory conviction) that embedded compensation is "bad" and that other forms of compensation arrangements would be much better for investors and industry participants. However, when one looks at trailer fees (leaving aside, for the moment, DSC (including low load) arrangements), it is clear that trailer fees are merely a packaging alternative to having an advisory fee paid apart from the management fees and expenses indirectly borne by the investors in the fund. In many instances, the current fee structure where trailer fees are paid by fund managers out of the revenue generated from the funds provides a simple, "all-in" cost to the investor.

In the Consultation Paper, a great deal is made of the following:

- investors are said to be not fully aware of the embedded compensation; and
- if investors paid for advice outside of the fund, they would be more aware of the fee and, as a result, have bargaining rights, including more control over the fees they pay.

Yet the Consultation Paper provides no real evidence of this correlation.

We find it very disheartening that after requiring industry participants (fund managers and dealers) to spend literally hundreds of millions of dollars to comply with pre-sale Fund Facts delivery and CRM2 disclosure obligations, the CSA members are quick to conclude that these measures do not – and indeed cannot - adequately inform an investor who cares to equip herself with the knowledge of the cost of her investment and who performs which service for the investor. The reality is that many investors will not take the time to read these documents – and only focus on "the bottom line", which is not to say that these documents are not useful and should be discounted. Arguably, with embedded compensation that "bottom line" is easier for the investor to understand as they see performance of the fund, after deduction of fees. The Fund Facts and CRM2 initiatives are still in their infancy, and, therefore, we firmly consider that it is premature to reach definitive conclusions on their ability to explain how the embedded compensation model works and impacts the investor's investment outcome.

If the CSA believe investors will not really read and understand the documents they will receive under Fund Facts (pre-trade delivery) and CRM2, why will they be any better off in a fee-based or direct pay account? There is no evidence or factual basis for any assertion that the fact that investors are paying an account level or direct pay fee will be any better understood at the time of payment or account opening, or on an ongoing basis. Arguably, investors will be worse off as they may be inclined to focus only on the fund performance, which naturally looks better when one moves the dealer compensation outside of the fund. While on page 78 of the Consultation Report the CSA address the potential inconvenience of the separate fee payment, there is no real discussion about how this fee will appear on account statements or in the presentation of fund performance, and how these presentations and fee payments would create a tangible positive difference in investor understanding.

No evidence has been provided to suggest that the average retail investor would have any ability to negotiate the fee that they would pay for advice in a fee-based account or in a direct pay scenario, which is one of the other key assumptions underlying the Consultation Paper. Indeed, in its Report, the Brondesbury Group expressly concludes "no empirical studies have been done to document whether investors have greater after-fee investment returns with fee-based compensation instead of commission-based compensation" (page 20) and that "some experience in jurisdictions that have banned commissions suggests that the net benefit for investors remains elusive" (page 20). In our experience, fee-based accounts for smaller account sizes are not typically negotiable and can be higher than embedded commissions, especially in the case of investments in bond and fixed income funds.

This point seems to be lost in the Consultation Paper, which instead focuses only on quoting the "obvious conclusion" from the Brondesbury Group report – that embedded compensation negatively impacts performance when compared to funds without embedded compensation. This suggests that the CSA may not have given sufficient weight to the different, and simpler, packaging argument. When one considers banning or restricting one alternative, it is critical to have fully compared it to the other likely alternatives. In our view, a complete analysis is missing from the Consultation Paper.

Also, if the "sticker shock" of seeing the dealer fee broken out in the manner contemplated in the Consultation Paper were to cause investors to cease to invest or to pursue other investment options which offer less advice, it is an open question whether this would be beneficial to the average investor – many of whom are by their nature not "do-it-yourself" investors with the resources or financial literacy (not to mention inclination to go it alone) to produce superior investment outcomes.

In addition, the Consultation Report does not provide many details to support the "bias" argument - that is, representatives of dealers provided biased advice based on compensation alone. In our experience, trailing commissions are fairly standardized across the industry, with many of the exceptions which existed in the past having disappeared in response to market competition and unfavourable perception pressures.

We also note that the Consultation Paper makes much of the lack of description of what services the investor receives in return for his/her indirect absorption of trailer fees and whether investors get services of commensurate value, but does not question whether the same would be true for other alternatives of direct payment for distribution services by investors.

The Consultation Paper indicates that the embedded compensation structure results in cross-subsidization, with the suggestion that this is a negative. Investment funds, by their nature, involve elements of cross-subsidization and that as fund structures evolve, the level of cross-subsidization is diminishing. We would suggest that fee-based accounts are also subject to cross-subsidization. Just like funds with embedded compensation where, until one crosses a particular threshold, the investor is paying the same fees as investors with less (and potentially considerably less) money, investors in fee-based accounts are also subject to pricing that only changes at certain break points.

To suggest that a retail investor, armed with the knowledge that they are paying an account-based or direct-pay fee, will suddenly have much better control over the fee they pay strikes us as unrealistic and, at the very least, not backed by any empirical evidence. There is no reason to believe the smaller investor will have any negotiating power to lower his or her fees. If they are put off by the "cost" of advice they may gravitate towards "no advice" or very generic advice options which offer less investor protection (and potentially less ability to meet investment objectives) for those who need it most.

At page 80 of the Consultation Paper, the CSA acknowledges the very real possibility of product arbitrage. In our view, if the CSA conclude significant changes must be implemented we submit these should only be made once this product arbitrage issue has been addressed. Failure to do so may well leave investors with a worse possible outcome in the longer term.

We believe it would be completely unreasonable to eliminate the right to collect redemption fees payable under DSC arrangements that were entered into in good faith by fund companies and investors prior to the announcement any new rules as is suggested as a possible outcome on page 82 of the Consultation Paper. This would interfere with contractual arrangements that were entered into in good faith and fail to recognize the funding obligations of the fund companies which are inherent in offering an investor the option of having all of the investor's money invested without the payment of a front-end commission.

2. Assumption that Embedded Compensation Creates an Insurmountable Conflict of Interest – Fact? Or CSA Assumption? Implications of Such Assumption

The Consultation Paper discusses conflicts of interest resulting from embedded commissions; more specifically, it states embedded commissions create a conflict of interest that misaligns the interests of investment fund managers, dealers and representatives with those of the investors they represent. This deviation in interest, changes the behaviors of said fund managers, dealers and representatives at the "expense of the market efficiency and investor interests." (page 11) Thus, the CSA proposes that embedded commissions should be avoided [that is, prohibited] in favour of different compensation structures.

In the context of registrants, the CSA explain in the Companion Policy to NI 31-103 (section 13.4) that a registered firm must identify conflicts that should be avoided, determine the level of risk that a conflict of interest raises and respond appropriately to the conflicts of interest. The CSA also outline three methods to respond to conflicts of interests, namely, avoidance, control and disclosure.

Specifically, in the area of avoidance, the CSA state that if a registrant allows a serious conflict of interest to continue, there will be a high risk of harm to clients or to the market. If the risk of harming a client or the integrity of the markets is too high, the conflict needs to be avoided. Registrants must avoid all conflicts of interest that are prohibited by law. If a conflict of interest is not prohibited by law, registrants should avoid the conflict if it is sufficiently contrary to the interests of a client that there can be no other reasonable response.

Accordingly, the guidance suggests that avoidance as a means of response to a conflict of interest is required where "there is a high risk of harm to clients or the markets", where the conflict is prohibited by law or where the conflict is "sufficiently contrary to the interest of the client that there can be no other reasonable response".

In our view, the Consultation Paper does not apply the aforementioned tests to the conflict of interest presented by embedded commissions, which makes it difficult to understand the basis for the CSA's position that conflicts of interest related to embedded commissions should be responded to by compulsory avoidance.

The CSA outline different potential negative impacts of embedded commissions on the market, without any analysis linking those negative impacts to a high risk of harm to clients or the integrity of the markets.

In particular, we are concerned that in failing to apply their own tests for avoidance of conflicts of interest as described in section 13.4 of NI 31-103CP, the CSA are, in effect, changing the tests and guidance in this respect. We submit that if the tests or guidance on when a conflict of interest must be avoided are changing, this needs to be clearly articulated to the market and in particular, to registered firms. Also, it needs to be articulated in a way that allows registered firms sufficient time to identify such conflicts and restructure their systems and affairs to implement an avoidance response to manage such conflicts of interest. However, we feel this approach would be misguided, given that we continue to consider that disclosure is the best option to moderate this potential conflict of interest.

Finally, the Consultation Paper discusses perceived conflicts of interest resulting from the commission structures at both the level of the fund manager and the dealer/representatives.

While it may be accurate to suggest that conflicts of interest exist for fund managers (in theory), that is, fund managers have a profit motive (more assets in funds equals more management fees), which causes them to incent dealers to distribute their mutual funds, we do not consider that a case has been made by the CSA that this conflict is at odds with the fund managers' duty to act honestly, in good faith and in the best interests of the mutual funds, as required under securities legislation. It is only when the conflict is elevated to this level that securities legislation requires consideration of the conflict of interest by an independent review committee of the mutual funds (IRC) under National Instrument 81-107. We are not aware of prevailing industry practices – or any earlier position of the CSA – that would suggest fund managers should refer trailing commissions or incentives paid to dealers to the IRC of the funds for a recommendation. In our view, the CSA regulate this area in ways that moderate the most obvious conflicts of interest for fund managers through National Instrument 81-105. It would only be if the CSA considered that NI 81-105 did not operate to deal with the conflicts inherent in a commission-based industry, that further action would be necessary. We do not consider that simply paying commissions for

distribution services means that the fund manager is acting without regard to its fundamental duty of care towards its mutual funds. We find particularly tenuous (and an example of an opinion being stated as a fact by the CSA) the assertion made throughout the Consultation Paper that mutual fund managers are more reliant on compensation and incentives paid to dealers to gather in assets than performance. In other words, performance is less important to fund managers than paying dealers to sell their funds according to the CSA, which assertion is not supported by evidence and our experience of working for many years with fund managers.

We understand that commissions and incentives may create conflicts of interest at the dealer and advisor level, which may lead (theoretically) to mis-selling of mutual funds (recommendations for mutual funds based solely on the compensation that the dealer/advisor will receive). However, again these conflicts have been regulated, since 1998 by NI 81-105 and through written and oral disclosure (enhanced as it is by CRM), as well as regulatory and legal standards of conduct on advisors and the dealer firms, who have extensive compliance monitoring obligations, including suitability requirements and supervision. The CSA explain that recommendations to investors by advisors cannot be made primarily on the basis of the compensation that the advisor will receive. We consider that this is an area where further discussions by the CSA with the SROs and their members may be useful. We comment on SRO regulation further below.

3. Continued Reliance on Clear Disclosure is Preferable to a Ban on Embedded Commissions

In our view, the recently implemented regulatory initiatives of pre-trade fund facts disclosure and the client relationship model initiatives should not be dismissed as effective mechanisms to alleviate the concerns noted in the Consultation Paper. We are firm in our view that the CSA should continue to monitor the impact of these initiatives before proceeding with a rule to ban embedded commissions. The increase in investor awareness that has the potential to result from these initiatives will allow investors to better assess the conflicts posed by embedded commissions (assuming they exist) and better evaluate whether the benefits of the services provided by their dealing representatives outweigh the costs. If these documents are considered to be deficient in some way by the CSA, we ask (as noted above) why the industry was required to implement these proposals with the degree of prescriptiveness and precision inherent in the proposals. If these documents and the delivery mechanisms to investors are deficient, then we urge the CSA to explain why – and undertake a serious rethinking of the nature of disclosure and the myriad of disclosure requirements that exist in current securities regulation.

The notion that investors should be given the freedom to make their own investment decisions, provided that they have access to all relevant information, is a fundamental – and long-standing - tenet of securities regulation. As a general principle, the purpose of disclosure in securities law is to promote equality of opportunity and information for all investors in the market. The CSA have relied on this principle in crafting regulation that requires timely disclosure by the issuers, advisers and distributors of financial products in instances of material change, knowledge asymmetries and conflicts of interests. Disclosure of relevant facts is intended to allow the investor, when apprised of such disclosed information, to make reasonably informed investment decisions on a level playing field with other participants in the market. We find it concerning that the CSA state (as they do throughout the Consultation Paper) that disclosure is now not sufficient and will never be able to work to mitigate any conflicts of interest – at least not ones similar to the conflicts of interest that the CSA consider are inherent in embedded commissions.

The Consultation Paper suggests that the implementation of point of sale disclosure and CRM initiatives will not address the inherent conflict of interests posed by embedded commissions, which, the CSA argue, incent dealing representatives to recommend products that maximize their revenue and incent investment fund managers to compete for sales on the basis of compensation they pay dealers, rather than performance. The implication of the Consultation Paper is that the conflict of interest posed by embedded commissions is so great that even disclosure of those conflicts does not provide investors with sufficient protection and that avoiding the conflict entirely is the only viable option.

There are several instances outside the context of embedded compensation in which conflicts arise between a registrant and its client where the CSA has long agreed that relying on disclosure to provide investors with sufficient protection. For example, a dealing representative that enters into an arrangement to pay for client referrals must disclose such arrangement to any client so referred. The purpose behind this disclosure is to alert the client that the referring individual was compensated for making such referral so that the client may take that fact into account when evaluating the merits of the representative's services and recommendations. Further, a registered firm that makes a recommendation to a client to buy a security issued by a related issuer must disclose the nature and extent of the relationship between the firm and the issuer. The purpose behind this disclosure is to alert the client that the registered firm has a relationship with the issuer that may influence the registered firm's recommendation. This disclosure provides the client with an opportunity to take that fact into account when weighing the potential benefits of making the investment against the potential risk posed by the conflict.

These disclosure requirements, amongst others, recognize that conflicts of interest may exist between more sophisticated financial services participants and clients who rely on those firms. For the sake and necessity of efficiency in the capital markets and providing investors with broad investment opportunities, instead of mandating that these conflicts be avoided, these rules require that conflicts are disclosed so that the investor can determine whether the cost or risk (i.e. the potential that the registrant may put its interest before that of the investor) is reasonable for achieving a desired outcome.

There are, of course, instances where the CSA has determined that a conflict is only appropriately mitigated when avoided. Conflicts must be avoided by operation of section 13.4 of NI 31-103 where they are prohibited by law or if the conflict is "sufficiently contrary to the interests of a client that there can be no other reasonable response". This is a high threshold, and in our experience these examples arise when there is a true risk of self-dealing to the strong potential detriment of the client. We submit that the conflicts of interest identified in the Consultation Paper relating to embedded compensation do not rise to this high threshold.

Like the examples set out above, point of sale disclosure and the CRM initiatives provide investors with fulsome disclosure of the costs and potential conflicts that arise when investing, as well as the potential benefits of such investment, so that investors may make a relative assessment of the risks and potential rewards. It is useful to reiterate the cost and performance data that are disclosed to clients at each stage of their investment:

Point of Sale: The CSA notes that fund facts aim to improve fee transparency by disclosing the costs of buying, owning and selling mutual funds. A fund facts document delivered at the point of sale discloses:

- Sales charges at the time of purchase
- Deferred sales charges at the time of redemption
- Trailing commissions paid to the dealer by the investment fund manager
- Management expense ratio
- Trading expenses ratio
- Total fund expenses

In addition to fee transparency, the fund facts document also provides data on performance of a fund, including:

- Annual total return of a series for either the past 10 years or since the series' inception (whichever is less)
- The best and worst returns for the series in a three month period over either the past 10 years or since the series' inception (whichever is less)
- The value of a hypothetical $1000 investment in the fund over either the past 10 years or since the series' inception (whichever is less)
- The annual compounded rate of return that equates the hypothetical $1000 investment to the final value

The fund facts document allows investors to get a sense of the initial and ongoing costs of investing in a fund and the potential risk and reward of the investment (based on historical data).

CRM2: CRM2 introduced new disclosure requirements relating to investment performance at the account level and the commissions and other amounts paid to dealers:

- **Account Opening:** Investors receive information on charges they may expect to pay in connection with their investment. If they invest in a fund, this information should include:
    - The management fee
    - The initial sales charge and DSC options available to the client
    - Any trailing commission or other embedded fee
- **After a Trade:** Following a transaction, investors are provided with a trade confirmation that discloses each transaction charge, deferred sales charge or other charge applying to the transaction, and the total amount of all charges.

- **Annually:** Annual reports now provide a summary of all charges incurred by the client and all compensation received by the dealer, including:

    - Total dollar amount of transaction charges

    - Total dollar amount of each type of payment other than a trailing commission made to the dealer or its representatives by another registrant in relation to registerable services provided to the client, which would cover upfront commissions investment fund managers pay to dealers for sales made under deferred sales charge arrangements

    - Total dollar amount of trailing commissions received by the dealer in connection with securities held

  The annual report also shows a detailed breakdown of performance, including the change in market value of the account, and the annualized total percentage return of the account for the last year, the last three years, the last five years and the last ten years.

All of the above disclosures aim to provide mutual fund investors with detail of the cost of investing and the performance of investments, at a product level (in the case of fund facts disclosure) and at an account level (in the case of CRM2). This increased awareness will allow investors to better understand the conflicts that may exist in an embedded fee structure and prepare them to evaluate these conflicts. Repeated disclosure about fees and compensation (at the time of account opening, at the time of investment, after investment, and annually) will allow investors to, over time, become more educated and informed about the fees they are paying. The CSA have stated that "increased performance reporting coupled with the increased saliency of fund costs and dealer compensation should cause investors to question the services provided by their representatives" who are in turn expected to respond by demonstrating their value proposition and reviewing the level of services provided. We submit that the CSA and industry should monitor how this process materializes before rejecting the effectiveness of these disclosures.

4. Commentary in the Consultation Paper does not sufficiently recognize the impact of SRO Regulation.

In our view, the CSA should consider very carefully SRO regulation of dealers and representatives before making the sweeping statements about whether or not trailing commissions and other incentives paid by fund managers create insurmountable bias and conflicts that requires embedded commissions to be banned. In our view, existing SRO regulation serves to moderate many of the issues noted as problematic by the CSA.

(a) Suitability should remain distinguished from and not confused with performance. Any discussion of performance should, in turn, include a full discussion of risk, its meaning and consequences.

The Consultation Paper states that embedded commissions raise conflicts of interest that misalign the interests of fund managers, dealers and representatives with those of investors in that it may:

- reduce the fund manager's focus on fund performance, which can lead to underperformance;

- give rise to compensation bias to incent dealers and representatives to recommend higher cost fund products that pay them higher embedded commissions other than other *suitable* lower cost and, preferably *better performing* products.

The Consultation Paper also states that investors may be caused to question the true costs and value of their services and that the CSA "… anticipate(s) that investment fund managers may respond to dealers' different product demands by producing lower-cost funds and focussing more on performance, thus potentially increasing competition and market efficiency" (p. 87). It says that there may be a "reduced incentive for products to be recommended on the basis of inducements received by the representative – potentially leading to a shift in recommendations from funds that were inappropriately favoured to *those that may be more suitable* for an investor. *If these funds are better performing funds, the shift in recommendations may reward better performing* investment fund managers with an increase in market share … (p. 90). Similar comments are made at page 93 of the Consultation Paper:

- "…. Dealers and representatives would specifically be required to consider the *impact of their compensation on performance as part of their suitability analysis*. To the extent that a product is recommended because it benefits the dealer or representative but there is an *equally suitable* product on the dealer's list that *would be less costly* for the client, such recommendation would not comply with the suitability obligation or the dealer's general duties to their client" ;

- "Combined with enhancements to KYC, KYP, suitability and proficiency, the CSA anticipate that representative recommendations *may shift to more suitable products* that may be lower cost possibly better performing products. To the extent that the CSA CP 33-404 proposals result in shifts in product recommendations *toward lower cost and better performing products,* we anticipate that these proposals may also have the indirect effect over time on investment fund managers as they may respond to these shifts by producing lower cost funds *and place greater emphasis on performance.* " .

We encourage the CSA to maintain concepts of suitability and performance distinct from one another as they may be easily confused in some instances, in particular those instances where investors have not enjoyed positive or more positive ("better") performance. Current legal and regulatory expectations in respect of suitability, as further described herein, require an in depth review of an investor's financial circumstances, investment objectives, risk tolerances, time horizon and investment knowledge. Performance does not form part of a suitability review. In other words, an investor may be suitably invested in every respect, while not having enjoyed positive or better performance or profitable investments. The lack of profitability or performance does not equate to a registrant failing to make a "suitable" recommendation.

Similarly, caution should be exercised so that a "more suitable" recommendation is not seen as a more profitable one or one that simply had lower fees. There may be multiple reasons for recommendation of one product over another to an investor, particularly where those products are not identical in all key regards, apart from fees, which may be one of a number of considerations.

Finally, any discussions regarding 'better performance' should be had in the context of a fulsome discussion of market risk and its various aspects and how that risk may be uniformly defined as amongst all members of the CSA, all SRO and all market participants, which uniform definition currently remains lacking. Such a discussion should also address the CSA's underlying assumptions with respect to risk and the necessary role it plays as a tool in market investments.

(b) Regulatory policies should endorse the regulatory rules and expectations surrounding ongoing advice and recommendations which are not limited to trades but include recommendations to invest (and hold) over the longer term

The Consultation Paper states that the CSA believe investors do not receive ongoing advice from dealers and representatives that is commensurate with ongoing trailing commissions paid. In particular, it states as follows:

- "If investors are getting basic one time services centred *on the trade* as opposed to ongoing advice and services in exchange for ongoing embedded commissions paid out of their funds' management fees, they may be indirectly paying too much for the services they are actually receiving. (p. 15)

- Moreover, since the aggregate amount of embedded commissions that investors pay increases as their holding period increases, those investors who remain invested longer may pay more fees than others for the same basic service. (p. 15)

- There is also the possibility that some representatives may have less of an incentive to service clients after the initial sale were we to move to more widespread use of fee-based arrangements. This may lead to "reverse churning", in turn defined as when a dealer places a customer's assets in a fee-based account (or receives some form of asset-based compensation) chiefly to collect the fee then subsequently does little for the client, in terms of actual advice, trading or account activity, in exchange for that fee. (p. 65)

- Embedded commissions will 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'. This misalignment in turn, may cause investors to pay more fees than necessary relative to the services they receive, thus impending returns (p. 89).

- **…** there is currently no securities regulation that prescribes, or guidance that articulates, the specific services that an advisor is expected to provide in exchange for ongoing trailing commissions. Under N1-31-103…. Dealers/representatives are required to provide certain services at that time of the trade (eg. Suitability, know your client) but no requirement to provide ongoing advice focussed on the client's portfolio (p. 122 Appendix A).

Somewhat similarly, IIROC Notice 17-0093 dated April 27, 2017 states in part as follows:

> *When asked by Dealers to justify this preferential payout for fee-based revenue, most said they believe fee-based accounts align registrant interests with client interests better than commission based accounts. While this may be true in some cases, there are other cases such as "buy and hold" where the client will be paying ongoing fees without receiving a commensurate level of ongoing service. Certain dealers also stated that, given the attention placed on embedded commission by the CSA, they are focussing on fee-based as the alternative.* (pp. 16, 24)

We consider these assumptions to be not supported in regulatory policy and industry practice.

Our regulatory regime has moved beyond obligations based solely upon a trade. Recommendations to buy and hold are encouraged and prudent for investors with a long term strategy and time horizon. Such recommendations do not imply a lack of duty on registrants and as such we cannot assume a lack of activity of their part in all instances.

IIROC Dealer Member Rule 1300.1 (p) to (r) provides that a suitability determination is required when an order is accepted, *when a recommendation is provided and when certain events occur* (as discussed further below). A recommendation to hold requires consideration of a client's current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the account's current investment portfolio composition and risk level. In order to further comply with the requirements under Rules 1300.1 (p) to (r), due diligence must be used to ensure that the suitability of all positions in the client's account are reviewed and the client receives appropriate advice in response to the suitability review that has been conducted.

Under IIROC Rule 1300.1, a suitability analysis must also be performed when securities are received into a client's account by way of deposit or transfer, there is a change in registered representative or portfolio manager or there is a material change in the client's life circumstances or objectives that has resulted in revisions to the client's 'know your client' information as maintained by the dealer.

IIROC Notice No. 12-0109 dated March 26, 2012 provides that:

- all recommendations must be suitable to the client. Suitability of orders and recommendations need be considered based on factors included the client's current financial situation, investment knowledge, investment objectives and time horizon, risk tolerance and the account's current investment portfolio composition and risk level.

- the regulatory obligation to ensure that orders and recommendations are suitable includes not only an obligation to ensure that the specific investment product is suitable for the client but also the order type, trading strategy and method of financing the trade recommended and /or adopted are also suitable;

- the suitability analysis starts before the order is even received, recommended or executed; and

- good business practices encourage holistic suitability reviews which would include periodic suitability reviews of client accounts, suitability reviews of accounts that may be affected by significant market events and of accounts holding securities that have undergone a material change in risk profile.

IIROC Notice No. 12-0109 also provides that account information must be updated any time there is a material change in a client's circumstances and recommends annual contact with clients to verify the accuracy of account information.

Like IIROC Rule 1300.1, MFDA Rule 2.2.1 (c) provides that that each order accepted or recommendation made (including recommendations to borrow to invest) for any account is suitable for the client based on the essential facts relative to the client and any investments in the account. MFDA Rule 2.2. 1 (e) has the same trigger events for a suitability assessment as IIROC Rule 1300.1.

MFDA Bulletin MSN -0069 dated April 14, 2008 sets out guidance for maintaining accurate and complete KYC information, know your product and the suitability process, all of which are applicable to a hold recommendation.

All of the above-noted regulations are cited in support of the fact that there is much more to a "recommendation" to invest in an investment fund than is acknowledged by the CSA.

(c) Unsuitable Leverage Strategies are fully addressed by SRO standards, particularly by the MFDA

The Consultation Paper states that the CSA also believes the discontinuation of embedded commissions would also eliminate the incentive for representatives to potentially engage in unsuitable leverage strategies (as explained in Appendix A") (p. 70).

It is unclear from the Consultation Paper just how embedded commissions have proven to be a meaningful incentive for unsuitable leverage strategies. It is of note that the MFDA in particular has expended multiple efforts to ensure suitability of leverage, samples of which are found in their rules, policies and notices.

MFDA Rule 2.2.1(c) requires that recommendations to borrow to invest be suitable based on essential facts relative to the client and any investments in the account. MFDA Rule 2.2.1(f) provides that to ensure the suitability of the use of borrowing to invest is made whenever the client transfers assets purchased using borrowed funds into an account, whenever the dealer or adviser become aware of a material change in client information or there has been a change in the adviser responsible for the account and where the use of borrowed funds is determined to be unsuitable, the client is so advised and provided recommendations to address the inconsistency.

Part III of MFDA Policy No. 2 describes procedures for identifying and reviewing leveraged transactions and in particular, minimum criteria that require supervisory review and investigation including investment knowledge, age, time horizon and financial circumstances.

MFDA Bulletin MSN-0069, Suitability, sets out multiple responsibilities regarding leveraged transactions. It states in part as follows:

> Leverage is not suitable for all investors and the appropriateness of a recommendation to use leverage must be assessed on a client-by-client basis, having regard to the client's age, financial circumstances, objectives, risk tolerance, time horizon, the manner in which they intend to secure and repay their loan and any other factors that are known at the time or reasonably ascertainable and may be relevant in the circumstances.

MFDA Bulletin MSN-0069 provides further detailed guidance regarding Part III of MFDA Policy No. 2. In addition, MFDA Notice MSN 0074 dated May 19, 2010 sets out the MFDA's requirements for clear, plain language, leverage risk disclosure for investors.

(d) The practical needs and realities of an aging population should remain part of a frank discussion with both the CSA and the SROs and it is not a sufficient answer to ban embedded commissions

Finally, the Consultation Paper states that the CSA believes that embedded commissions incent unsuitable use of DSC arrangements and refer to MFDA Compliance Bulletin No. 0670-C, 2015 DSC Sweep Report, December 18, 2015, which uncovered instances of inappropriate use of DSC. The Consultation Paper points out that this included: "clients over the age 70 that were sold funds under DSC arrangements" and "clients that were sold funds with DSC redemption schedules that are longer than their investment time horizon" (p. 109).

We recommend that all regulators (particularly the MFDA) take a meaningful look at the life expectancies of Canadians and their personal and financial circumstances which are unique to every individual irrespective of age. For example, a 70 year old may well live for at least another decade or considerably longer. Irrespective of his or her lifespan, he or she may wish to have sufficient funds for estate planning goals. In other words, a long term time horizon may well apply and a DSC option may be suitable for that client.

IIROC Notice 16-0114 dated May 31, 2016 recognizes that senior clients are not a homogeneous group and that issues that affect some, may not be relevant to all older clients. Product due diligence, know your product and know your client are considered to be most relevant in this discussion. IIROC also points out (correctly, in our view):

> *While the presumption is that senior clients' time horizon is the duration of their retirement, senior clients may have differing time horizons for their accounts (eg. where a senior client wishes to leave a legacy to a family member). Dealer members should ensure that the rationale to support the time horizon used for each senior client is appropriately documented.*

Each of these regulatory requirements would require a representative to consider the appropriateness of DSC features for their older clients.

5. Effect of a Ban on Embedded Compensation on Investment Fund Managers

The Consultation Paper does not discuss the potential impact on fund managers, particularly new or niche fund managers, that a ban on embedded commissions may very likely have. Today, trailing commissions or other up front commissions paid by fund managers to dealers not only reimburse dealers for the distribution services they provide investors, but they are designed, in

part, to also compensate dealers for the significant regulatory obligations relating to KYP and due diligence related to the funds they recommend to their clients. It would not be surprising to us if dealers were to narrow their shelf (particularly if the ban on embedded commissions were to be implemented alongside the "targeted" reforms discussed in the "Best Interest Standard" consultation paper) simply because the KYP and related due diligence were considered to be too onerous in connection with the investment funds managed by a new fund manager or a niche player or less well known fund manager. Furthermore, the elimination altogether of compensation from anyone other than the dealer's client could very well result in a further narrowing of the dealer's shelf, leaving only the most mundane of investment products, if there is no incentive or insufficient compensation for a dealer to invest the time necessary to do due diligence on, and assume the increasing regulatory risk of investing client money in, novel or alternative investment products.

We consider that this is a significant market-place issue that is deserving of consideration by the CSA. The ban on embedded compensation may have additional unintended consequences by reducing competition in the market-place and placing greater barriers to entry into the fund industry.

6. Missing Elements from the Consultation Paper

We point out several elements below that we consider to continue to be missing from the CSA's consideration of the issues around embedded compensation:

(a) The Consultation Paper does not discuss the tax considerations that are a key part of any discussion of investment funds, their fees and structuring. We urge the CSA to consider the tax aspects of their proposals before moving forward with them, if indeed this is the ultimate decision. We would be pleased to provide the CSA with any other information about taxation of investment funds and fees payable outside of the fund that the CSA might find helpful in this context.

(b) The Consultation Paper fails to acknowledge the CSA's regulation of mutual fund sales practices through National Instrument 81-105, which has been in place since 1998. This instrument contains rules that seek to moderate the conflicts of interest that are inherent in a commission, incentive-based distribution model. These rules also forbid fund managers to pay any money or incentives directly to dealing representatives (advisors). The CSA were very deliberate in its formulation of NI 81-105, including the extent to which the CSA would be willing to regulate specific incentive practices and commission levels. Any future CSA initiative in the area of mutual fund fees, must, in our view, include a consideration of NI 81-105, including any necessary reforms and updating of NI 81-105.

(c) The evolution of investment fund fees provided many *benefits* to investors, including considerations relating to changes in industry focus from front end load commissions to DSC to low load sales charges and also of investing in investment funds, generally, which include:

(i) With DSC and low load sales charges – 100 percent of the investor's cash is invested, whereas with front end load, particularly at the 8-9 percent

levels in the mid-late 1980s, the commission comes out of the initial investment, meaning less money is actually invested in the funds.

(ii) With DSC and low load sales charges – if the investments are held for the prescribed period (which has shortened over the years), the investor pays no sales charges at all.

(iii) Front end load commission based sales can lead to more active trading in investment funds (which may result in churning of investments, being traded in order to maximize commission based income).

(iv) The desirability of investor choice – provided there is appropriate advice and suitability assessments (which is inherent in the distribution model of registered dealers and representatives), coupled with clear disclosure, we consider that allowing for market-driven alternatives is fundamentally preferable to a regulated reduction in the ways that fees for services can be paid for by investors. We do not consider that the Consultation Paper gives enough credence to the desirability of giving investors choices in how they pay fees for services.

(v) Investment funds give the average retail investor access to a professionally managed pooled vehicle managed by professional money managers and administrators for a comparatively low cost and at low investment thresholds. Investment funds are easily accessed by investors working through thousands of dealing representatives (including as part of a more holistic financial planning exercise) and hundreds of dealer firms. In our view, investment funds are a real Canadian success story, with access to funds being (generally) available in all of the provinces and territories of Canada.

(d) Related to the above-noted comment, with manager-established commission structures – that is, fund managers set the level and type of compensation that will be paid to dealers (and therefore indirectly to advisors) – the parties have more equal negotiating positions than would be the case if investors alone were left to negotiate their fees (on an individual basis) with their advisors and dealer firms. Fund managers have interests that are aligned with investors (including smaller retail investors) – they want investors to invest in their funds, they want their product to be competitively priced vis a vis other financial products (including other funds) and they are required to act in the best interests of the funds. Accordingly, fund managers wish to incent dealers to distribute their funds, while not paying more than is necessary to achieve this objective. Fund managers have much more "clout" and negotiating power than do individuals, particularly smaller retail investors. The CSA should carefully consider the potential for unintended consequences if the current tri-party bargaining relationship is replaced with a two-party model with clearly unequal bargaining power between the parties.

Related again to the two above-noted comments, dealers and fund managers can be said to have a somewhat symbiotic relationship. This relationship feeds the

negotiating equality noted above, but also, in our view, led to the growth of the various compensation and incentive models discussed in the Consultation Paper and as regulated by NI 81-105. Because the majority of fund managers generally have no way to distribute their funds to the public (which is more of an operational rather than regulatory issue, given the tremendous operational, compliance and back-office operations that are necessary for a viable dealer network), fund managers must incent dealers to distribute their products, through commissions and other incentives, as well as good management, adoption of best practices and good performance. Similarly, dealers are dependent on fund managers to create and properly manage the funds that can be investment options for their clients. As noted above, the operational aspects that are necessary for a viable dealer network have costs which dealers, understandably, consider should be shared by fund managers through compensation and incentives, given the "sharing" of client relationships between dealers and fund managers. This relationship is a reality – but it is not inherently a negative reality, which is hinted at in the Consultation Paper.

7. Transition Issues Not Discussed in the Consultation Paper

The Consultation Paper does not discuss transition issues in the event that the CSA actually moves to ban embedded compensation. Would the CSA expect that managers will simply stop paying trailing commissions to dealers? Similarly, is the CSA expecting industry to create new series that do not include such embedded compensation and switch investors into that series?

Also, we note that insufficient attention has been paid to the fact that embedded compensation is 'embedded' in management fees -- a fund pays a management fee to its manager, who may then choose to share a part of that management fee with others, including dealers. Banning embedded commissions would not in and of itself change the quantum of the management fee charged by the manager to the fund. To the extent that managers choose to reduce the management fee charged to the fund in light of a ban on embedded compensation, it would not be reasonable to assume that the management fee would be reduced by exactly the amount of the current trailing commission.

Trailing commissions pay for service and advice that representatives and dealers provided to investors – we anticipate that managers may need to provide additional seminars and similar information sessions to assist with, for example, Know-Your-Product obligations because dealers may have less revenue to fund Know-Your-Product research to the extent they do now. Therefore, managers who wish to have a particular fund known to dealers, may need to hold information sessions to a greater extent than they would be required to do currently. Such sessions would need to be funded out of the only source of revenue available to managers – management fees.

Important transitional elements include the systems and operational changes dealers will have to adopt to provide for the ability to charge direct pay or fee-based account level fees. Fund managers will need to reconsider the series of funds they offer to the public. Significant time to allow for such implementation will be necessary.

If the CSA does decide to move forward with a ban on embedded commissions – it will be vital that the CSA carefully – and creatively – consider the transition for funds and industry participants alike. We recommend that the CSA hold a specific consultation on the transition that will be necessary, including recommendations as to modifications of the disclosure regime that today applies to funds, dealers and fund managers. A less prescriptive and inflexible – and more creative - approach to disclosure would be most welcomed.

8. CSA's Next Steps

Before moving ahead or taking any other steps regarding investment fund compensation, we urge the CSA to develop a holistic approach to regulating the industry – and to determine how each regulatory piece fits together at least at a high level. This would include an analysis of the considerable disclosure obligations on investment funds, managers and dealers and how these disclosure obligations fit with dealer and representatives' regulation (SRO and otherwise) and also regulation of conflicts of interest through NI 81-107, NI 31-103, NI 81-105 and NI 81-102, as well as existing securities legislation (Part 21 of the OSA, for instance). We consider that it is important not to focus so purely on the one element outlined in the Consultation Paper, being "embedded compensation through trailer fees and up front commissions" without considering other important matters that may give rise to similar conflicts of interest or important investor protection matters, such as charging of fees generally, operation and distribution of proprietary funds, revenue sharing, distribution of non-securities products (that do are not subject to the same regime as investment funds) etc, none of which are mentioned (other than to say they are not being discussed) in the Consultation Paper.

The Consultation Paper may raise important discussion points, but without understanding the balance of the regulatory regime and a complete picture of the entire industry, unintended consequences and unbalanced regulatory burdens will be created for different segments of the industry.

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We hope that our comments will be considered positively by the CSA and as helpful to advance the CSA's considerations of the important matters outlined in the Consultation Paper.

We would also be very pleased to organize a meeting with the lawyers who participated in the preparation of this comment letter to discuss our comments further with interested CSA staff if this would be considered useful.

The following lawyers participated in the development of this comment letter:

Whitney Bell, Jason Brooks, Rebecca Cowdery, Fred Enns, Kathryn Fuller, John Hall, Ron Kosonic, Lynn McGrade, Laura Paglia, Donna Spagnolo and Prema Thiele.

Yours very truly,

Borden Ladner Gervais LLP

(Investment Management and Securities Practice Group Lawyers)