CSA CONSULTATION PAPER 81-408- CONSULTATION ON THE OPTION OF DISCONTINUING EMBEDDED COMMISSIONS

January 10, 2017

Comments

To:

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

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

   Yes. The potential conflicts of interest could misalign reps and investors.

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

   No comment.

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.*

   Not in our view.

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

   - *mutual fund*

   Yes.

   - *non-redeemable investment fund*

   No comment.

   - *structured note*

   No comment.

   Should the product be subject to the discontinuation of embedded commissions?

see answers above)

If not:

a. *What would be the policy rationale for excluding it?*

No comment.

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?*

Significant arbitrage risk could be an influence.

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?*

No – in order to ensure no arbitrage of the system.

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

We believe it should apply to all.

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?*

Yes.

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?

We believe that the existing rules should be diligently enforced, and that there needs to be a safe whistle blower system.

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?*

   We feel it is too early to say.

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?*

    We have seen improvement in this regard.

    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?*

    Yes.

    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?*

    No comment.

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.*

    No comment.

Where possible, we strongly encourage commenters to provide data to support responses.
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?*

    We believe it is a great initial step.

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?*

    No comment.

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?*

    This is very possible. Issuers evolve and adapt, so further revisions may be required at some point.

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?*

    Yes.

    - *What effect will the proposal have on the growth of automated advice? Is this likely to be beneficial to investors?*

    No comment.

    - *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?*
    -

    Yes. That is what we would expect.

    - *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?*

    We expect it to be beneficial to investors.

    - *What effect will the proposal have on the cost and scope of advice provided to specific investor segments?*

    We expect the effect to be positive.

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?*

We would hope not.

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

We do not think this will occur.

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?*

We agree with your definition.

- *Should we differentiate between an advice gap for face-to-face advice and an advice gap generally?*

No opinion.

- *What types of advice or services currently provided today would be most affected by the proposal?*

No comment.

- *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?*

No comment.

- *How could a potential advice gap, face-to-face advice gap or financial service gap be mitigated?*

No comment.

- *Do you think that online advice could mitigate an advice gap? If so, how?*

We believe that online advice could mitigate an advice gap to some degree.

- *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?*

Yes.

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?*

    We do not believe this would occur.

    In particular:

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

    No. If it did, it would be very slow to do so.

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

    We concur that it is accurate.

    In particular:

    - *Do you see payment options and business models evolving at present?*

    No comment.

    - *How are they likely to change over time if the CSA were to choose not to move forward with the proposal?*

    No comment.

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?*

    The continued availability of embedded commissions.

    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?*

    No comment.

    - *What are the likely impacts on investor outcomes and market efficiency of any potential consolidation?*

We would expect the efficiency to remain.

- *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?*

No comment.

- *What is the likelihood and magnitude of regulatory arbitrage across similar financial products such as segregated funds and deposit-taker products?*

There could be an increase in regulatory arbitrage.

- *What would be the impact on dually-licensed mutual fund dealers and insurance agents?*

Potentially more commission based products.

- *Will the proposal lead new, lower-cost entrants to the market? Why and how?*

Hopefully yes – and greater breadth of products.

- *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?*

No.

- *Will a transition away from embedded commissions reduce fund series and fee complexity, as we have contemplated?*

Yes.

- *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?*

Yes.

- *What are the potential effects on competition of the rise in online advice? Are these effects likely to be large and positive?*

No comment.

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

    No comment.

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

    No comment.

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?*

    No comment.

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?*

    No comment.

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?*

    No comment.

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?*

    No comment.

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?*

No comment

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

No comment.

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:

a. 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.

b. 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?

c. What, if any, measures, regulatory or otherwise, could assist in mitigating potential operational and tax impacts?

No comment.

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,

a. 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?;

b. 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

c. what measures may mitigate the potential effects on dealers, representatives and investors from the loss of the cross-subsidy?

No comment.

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

No comment.

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

No comment.

33. 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?

No comment

34. 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.*

No comment.

35. 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.

No comment.