PORTFOLIO Strategies

June 9, 2017

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

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

Re: Canadian Securities Administrators Consultation Paper 81-408
Consultation on the Option of Discontinuing Embedded Commissions

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Portfolio Strategies Corporation ("PSC") is a Calgary-based dealer that is a member of the Mutual Fund Dealers Association of Canada and registered as a mutual fund dealer and exempt market dealer in Alberta, British Columbia, Saskatchewan, Manitoba, Ontario, and Québec, and as an investment fund manager in Alberta and Ontario.

We appreciate the opportunity to provide comments on the CSA's Consultation Paper 81-408 (the "Consultation Paper"). Below we provide our overall comments followed by our responses to the 36 questions posed in the Consultation Paper.

Questions from the Consultation Paper

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

Overall, we do not agree with the issues described in Part 2. Specifically:

- There is an implication throughout that investors would pay lower fees if there were no embedded commissions. However, that implication rests on the assumption that individual investors will be able to negotiate a fee directly with their financial advisor that is lower than the embedded trailing commission. The information asymmetry that exists with respect to the current variety of fee options will also exist during one-on-one fee negotiations, since few clients will have an objective basis to assess whether the fee rate offered to them is high, low, or "just right". In addition, most people are simply not good negotiators who try to avoid "haggling", and in many other aspects of their lives pay whatever price is offered. At present, trailing commissions are quite standardized across the mutual fund industry for a given type of fund, which gives investors assurance that they are not paying excessive fees.

- The suggestion that fund managers are focused on embedded commissions to the detriment of fund performance does not accord with basis economic or business sense. Financial advisors typically are, and seek to be, in long-term relationships with their clients. A financial advisor who recommends a poorly-performing fund with the goal of receiving a trailing commission of, for example, 0.10% more than a better-performing alternate fund risks losing many years of revenue from clients who are disgruntled due to the poor performance and leaves for another advisor. For that reason, there have been many funds, and even some fund families, that paid average or above-average sales and trailing commissions but nonetheless no longer exist because the fund performance was below-average and advisors moved their clients to better funds. Footnote 96 is entirely speculative, since there is a long history of financial advisors moving clients away from poorly-performing funds.

- The Canadian Securities Administrators ("CSA") have significantly increased the amount and types of disclosure about mutual funds in the past three decades, including about costs and compensation, but the Consultation Paper notes in passing that those disclosures have not improved investors' awareness or understanding of the nature, types, or amounts of fees related to their investments in mutual funds. Client relationship model ("CRM2") amendments to *National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations* came into force in 2016 that require detailed disclosure of all types of compensation that registrants receive related to each investor. The Consultation Paper similarly notes that these additional disclosures are not expected to address the CSA's concerns. Despite the significant costs that the industry has incurred to meet the CSA's ever-changing disclosure requirements, the CSA itself does not appear to believe that additional disclosure has achieved much. There is little reason to believe that the additional disclosure to clients in the form of seeing unembedded fee amounts on their statements will achieve a different result.

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

We do not agree with the assumption that there are significant issues or harms to investors due to embedded commissions. Without embedded commissions, advisors won't be paid for ongoing

service such as KYC updates which are required in order to provide appropriate advice but which client's don't see as a benefit.

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.*

Embedded commissions, particularly trailing commissions, are more efficient because they can be calculated and managed on a large scale by the fund companies. It is more time-consuming – and therefore more costly – for a dealer to perform the fee calculations and deductions at an individual account level. As the Consultation Paper notes, fee-based accounts are typically only offered for larger clients. This is due to the overhead involved and will necessarily limit fee-based options to larger accounts. Also, due to the overhead involved, preventing embedded commissions and requiring dealers to offer fee-based accounts will increase the cost and risk of starting a new dealer, which will limit competition and further limit access to advice for smaller investors.

Unlike institutional money management where advisory services are provided at a generally consistent rate over the lifetime of the engagement, a significant proportion of the services that a retail client receives may be at the outset of the relationship. These services include debt management advice, cash management advice, estate planning, tax planning, retirement planning, and general financial planning, in addition to investment advice. It is commercially reasonable for a financial advisor to be paid for these services when they are provided. Many small- to medium-sized clients primarily hold their investment assets within registered plans, which cannot be accessed to pay for service. Embedded DSC sales commissions provide a mechanism for the financial advisor to be paid without the client having to incur taxes on withdrawals from registered plans or a reduction of their invested capital. Without this mechanism, there will be significantly less incentive for financial advisors to provide comprehensive service and advice to small- to medium-sized clients.

Embedded compensation is the only way that small investors will be able to access advice. For example, it takes most advisors one hour to go through the account opening paperwork for a new plan, including explaining all disclosures to the client, and then a further hour to discuss various investment options before a decision can be made. For an experienced advisor earning $150 to $200 per hour, the CSA should recognize that a client with a $2,500 RESP will not be willing to pay $300 to $400 for the service involved in opening an account, nor would the CSA find this acceptable.

It is widely recognized that the industry needs new advisors due to an aging advisor population. New advisors cannot afford to perform substantial work for a negotiated fee or an hourly rate that may go unpaid.

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?*

We do not agree with discontinuing embedded commissions for any type of products.

If the CSA are genuinely concerned about regulatory arbitrage, we believe that they should be taking a public position to remove the exemptions in securities legislation that allow segregated funds to be distributed outside the securities regulatory regime. In our experience, there is no meaningful regulation of segregated funds at the retail level, which exposes investors in segregated funds to unsuitable investments, unsuitable leveraging, and commission-driven churning. Insurance regulators have resisted making changes that would create a more level playing field with mutual funds or that would reduce arbitrage opportunities, and there is no reason to believe that any such changes will happen in the future.

The exempt market does not lend itself to fee-based, direct pay, or billable hours relationships. These products are often higher risk, start-up, venture capital investments with no or limited liquidity in the start-up phase. If embedded commissions were discontinued for exempt market products, many small- to medium-sized businesses would never get created, many of which become successful public companies some years down the road.

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 noted above, we do not agree with discontinuing embedded commissions for any type of products.

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

As noted above, we do not agree with discontinuing embedded commissions for any type of products.

Distribution channels that do not provide advice, such as discount brokers, should not be permitted to sell products that have embedded compensation.

Regulators may consider limiting embedded commissions to accounts below a certain dollar threshold.

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?*

For the reason set out elsewhere in our comments, we do not believe that the data presented by the CSA support discontinuation of all payments made by persons or companies other than the investor. It would be quite costly to implement a new direct billing system and this will necessarily increase end client fees.

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 do not believe that these types of payments represent risks to investors. We therefore believe that these types of payments should continue to be allowed.

With respect to underwriting services, there are substantial costs in time, staffing, and legal searches, and the underwriting community can't possibly absorb those costs.

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 are not aware of abuses of payments that are allowed by Part 5 of NI 81-105. We therefore do not believe that changes to the scope of these payments and benefits are warranted.

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?*

We do not believe that NI 81-105 has been effective in creating a level playing field. As we have seen in numerous articles in the media in recent months, the sales incentive and compensation

arrangements within integrated financial services providers has been subject to abuse to the detriment of investors and other clients. We believe that opaque compensation arrangements – the internal transfer payments – have likely contributed to the abuses. We therefore believe that internal transfer payments to dealers within integrated financial service providers should be required to be on a fully-disclosed basis and should be required to be made on the same basis as third-party compensation. Continuing to allow opaque or discretionary payments within integrated financial services providers will continue to favour dealers within that group – who are inherently conflicted by their investment fund manager relationships – over independent dealers. For example, many bank clients continue to believe that mutual funds at banks are “cheaper” because there are no explicit, disclosed commissions to other areas of the bank.

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.

Calculation and collection of fees at the dealer level is significantly less efficient than doing so at the fund or fund company level. Preventing investment fund managers from calculating, collecting, and remitting investors’ payments to the dealer on the investor’s behalf would limit the economical account size for dealers, especially for smaller dealers. Creating artificial barriers to entry and to profitability necessarily limits choice and competition. We therefore believe that investment fund managers should be allowed to calculate, collect, and remit investors’ payments to dealers on the investor’s behalf.

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?

For the reasons set out in the response to question 1, we do not believe that discontinuation of embedded compensation arrangements would meaningfully address the three key investor protection and market efficiency issues.

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?

We do not agree with the issues described in Part 2, with respect to distribution channels that provide advice. We therefore do not believe that the CSA need to take alternate measures to address them either.

We believe that the CSA should prohibit embedded commissions in non-advisory distribution channels, such as discount brokers.

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?

No.

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?*

In most respects, fee-based compensation within a client account that is calculated as a percentage of the assets in the account compared to embedded trailing commissions is a distinction without a difference. In each case the client is charged a fixed percentage of their account each month and the net effect on returns is unchanged whether the amount is deducted directly from their dealer account or from the net assets of the mutual fund. Unembedding fees is therefore unlikely to change the level of advice and service.

Further to the response to question 1, any assumption that investors will choose automated advice due to disclosure of unembedded fees in traditional accounts is contradicted by the CSA's finding that most investors aren't aware of their investment fees despite the copious disclosure given to them.

If the discretionary advice channel (portfolio managers) were interested in mass-market clients, there has been nothing to date stopping them from pursuing that segment. However, it is generally a more expensive relationship to service and maintain so portfolio managers do not pursue mass-market clients. From experience, it therefore is unlikely that eliminating embedded commissions would cause a shift to discretionary advice. If there were a shift, we believe that would be negative for most mutual fund clients because portfolio managers focus on investment management whereas the independent dealer channel generally focuses on broader financial planning as contemplated by CSA CP 33-404.

We recommend prohibiting embedded commissions in the discount broker channel. We recognize that transaction costs in that channel will rise when they aren't being cross-subsidized by embedded fees that were intended to compensate the dealer for advice.

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?*

As discussed in the response to question 3, much of the service for retail clients happens at the outset of the relationship. For large clients, financial advisors and dealers are more prepared to wait through the relationship to be compensated for the resources invested at the initial stage. For smaller clients, the payback from a fee-based account will take much longer. The result is that

larger clients, as they are today, are more likely to be offered a fee-based account, but smaller clients are more likely to be asked to pay sales commissions or a direct financial planning fee at the outset of the relationship.

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.*

There is already an advice gap, as proved by the OSC's own "mystery shopper" exercise where the OSC found that financial advisors were not prepared to accept new clients in the "mass market" asset range. We are not clear why the OSC and other regulators continue to ask whether there is or will be an advice gap when their own research has proved that it already exists.

As with all regulatory proposals that increase the cost to service clients or that are intended to reduce revenues from servicing clients, less wealthy clients will be most affected as they become less profitable, or unprofitable, to service.

- *Do you agree with our definition of an advice gap?*

We would extend the definition proposed in the Consultation Paper – "the group of investors who cannot obtain the amount of advice they desire at the price they are willing to pay" – to include investors for whom the direct cost of advice – without embedded commissions – is unreasonably high in relation to the amount of their investable assets.

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

Regulators should distinguish between the type of advice and services provided face-to-face, which is generally more comprehensive, and advice given through other channels, which is generally limited to investment advice. Given the different type of advice and service offered by the different channels, the proposal may create greater gaps in the comprehensive face-to-face channel.

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

Independent mutual fund dealers are typically focused on financial planning relationships with clients, as opposed to providing only investment management advice, and revenues from mutual funds pays for the financial planning. By limiting options, particularly by preventing DSC commissions from registered accounts, financial planning services will be limited for mass-market clients.

- *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?*

The "targeted reforms" proposed by CSA CP 33-404 require significant expertise from financial advisors, and require a significant investment of time at the outset of a client relationship to deal with, for example, debt and cash-flow management planning for the client.

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

We believe that embedded compensation remains a cost-effective method of mitigating the advice gap and therefore believe it should be allowed to continue.

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

Online advice may mitigate an advice gap to a small degree, but it is unlikely to provide more holistic financial advice, tailored to a client's needs, with respect to debt and cash-flow management, estate planning, tax planning, and matching broader life goals to the client's financial plan. Online advice only addresses the investment component, which is 10% to 20% of the service that a financial planner provides.

- *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?*

No. Banks don't want small accounts either and are not structured to provide comprehensive financial advice, so the advice gap will continue to widen. We would again refer regulators to the results of the OSC's mystery shopper exercise.

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?*

Yes, but only for larger accounts of $250,000 and up. We believe that both fee-based options and compensation from embedded commissions have appropriate roles within the investment industry, but forcing a fee-only model will prevent clients who are not economically viable under that model from being able to access advice.

Many small- and medium-sized dealers can't afford to implement fee-based accounts which may result in reduced choices and reduced competition in the industry.

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?*

Yes, larger accounts are moving to the fee-based model.

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

The transition will continue for lower-cost negotiated fee accounts through the use of technology. It started well before this proposal was published.

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?

Fee-based accounts are more expensive for dealers to operate than accounts that are remunerated through embedded commissions, which is why they have typically only been offered to more affluent clients. The increased costs are from personnel, systems, and compliance with additional regulatory requirements. Mass market accounts with average value of $50,000 do not fit within this increased cost 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?*

Yes, the proposal will cause further industry consolidation because smaller firms do not have the systems, personnel, and capital to compete. The result will be further concentration of mass-market investor assets managed by deposit-taker owned firms.

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

It will have an anti-competitive effect. Further consolidation in the industry will reduce competition, which will ultimately allow larger market players to dictate higher fees and reduced product choice.

- *What opportunities and what challenges do you think the proposal would introduce for specific industry stakeholder groups?*
  - *Independent dealers?*

Independent dealers don't have the scale to compete with banks in the low-fee, low-advice arena. Independent dealers can demonstrate differences in their planning services but need to be able to be paid.

  - *Independent fund manufacturers?*

Independent manufacturers may not have the staff and systems to calculate, collect, and remit fees.

  - *Integrated financial service providers?*

Integrated financial service providers will benefit from the proposal and move higher than their current 90% market share.

- *Mutual fund dealers?*

The proposal will increase costs with no corresponding increase in revenue which will hurt profitability and, for some independent firms, may hurt their economic viability.

- *IIROC dealers?*

IIROC dealers will gain market share because they already have platforms to operate fee-based accounts.

- *Online/discount brokers?*

Online and discount brokers will have to start charging, or will increase, account fees to recover the revenue they no longer receive from embedded fees.

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

There is a high likelihood of regulatory arbitrage in favour of segregated funds due to the lack of regulation on them. This harms clients. We have observed this happening for a number of years and insurance regulators have not yet taken steps to address the problem.

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

The proposal will lead to a shift to segregated funds, which are more costly to investors.

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

The proposal may encourage the use of robo-advisors but they do not provide the same range of services, which will further exacerbate the advice gap.

- *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, as set out above.

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

No, as fund managers will continue to feel pressure from regulators to offer discounted fees based on client account sizes in order to eliminate the risk of further fines from the CSA.

- *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?*

Absolutely. They are, for example, able to recover the operating costs of their branch network from banking revenue.

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

The effects are likely to be significant and negative. Again, the CSA is missing the point here. Planning is critical. Taxes are an investor's biggest cost, not the management expense ("MER") ratio. Tax mistakes can have a double-digit percentage negative effect on after-tax cash flow, whereas MER differences are likely to be under one percent.

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?*

Many smaller dealers, particularly in the MFDA channel, do not have systems that allow them to operate fee-based accounts. Systems can only deliver on this if dealers agree to pay for the information technology "build" and the maintenance of such systems.

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?*

We do not believe that a transition to direct pay arrangements would significantly change the need for controls and oversight. There have been many reported cases of dealers approving fee-based accounts that have cost the clients more than they would have paid in an account based on transaction fees, and where it was or should have been known from the client's account history that the fee-based option would cost more. A transition to direct pay or fee-based accounts is not a *panacea* for compliance since compliance will still have to assess and approve "reasonable fees" for accounts.

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 noted in the answer to question 15, fee-based charges compared to embedded trailing commissions is largely a distinction without a difference from a client perspective. From a dealer perspective, fee-based accounts are more expensive to operate which could result in mass-market clients paying higher direct fees in a fee-based account than they pay in the form of embedded trailing commissions. For smaller dealers, eliminating trailing commissions will make smaller mass-market clients unprofitable without any opportunity to recover the revenue elsewhere, apart from increasing the fee rates.

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?*

We are not aware of other approaches that might be available.

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?*

As in any industry, reduced compensation will make the industry less attractive and make recruiting more difficult, and the CSA's overall thrust is that investors should pay less for investment advice, but this is not about performance, MER, or alpha. The CSA should focus instead on getting advice out to the mass market. That will improve investor outcomes far more.

Many new entrants have relied, at least in part, on DSC commissions to earn enough money in their first one or two years in the business to cover the costs of the upfront financial, retirement, tax, and estate planning and risk management. By reducing the revenue stream, the industry will require new entrants who have sufficient savings to sustain themselves for longer periods. That will make it harder yet for younger individuals to enter the industry at the same time that the industry is suffering from aging. This could also lead to increased use of DSC segregated funds, or higher risk IPOs that still have embedded compensation, thus raising obvious conflicts of interest issues.

27. *How practicable are the mitigation measures discussed and how effective would these measures be at assuring:*

    - *access to advice for investors,*

Small- to medium investors will not pay for advice explicitly. Having fund companies collect fees and remit them to dealers might work.

- *choice of payment arrangements for all investor segments, and*

Don't remove choices like embedded compensation. Hourly fees don't work and will only shut out small investors.

- *a level playing field amongst competing investment products?*

There will be no level playing field if the advice channel is forced down to the no-advice channel pricing. There are two separate playing fields – advice and no advice.

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

Allow "no planning" client accounts, or do-it-yourself accounts, at independent dealers with reduced suitability requirements, similar to discount brokers.

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?

Increased use of self-directed registered plans, and open nominee accounts, will lead to investors having to pay annual plan or trustee fees that they had not paid previously. These plan types are the only way that investors can access lower cost ETFs and government bonds. These are not, and will not, be available at client name mutual fund accounts.

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.*

Yes. The sale of investments to make investors' payments could lead to realized capital gains on securities that are in a "gain" position.

- *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?*

Yes. Many consolidations could be deemed dispositions, leading to taxable capital gains with no associated cash flow to investors to pay the taxes.

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

Mitigation of the tax problems is outside the jurisdiction of the CSA.

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?;*

While many advisors use such cross-subsidies in their practices, it is by their choice and not our firm's policy or strategy. The obvious consequence will be much higher fees to get good advice in the hands of lower-wealth investors.

- *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*

We note that in any profitable business, total fees must exceed the actual cost of services provided. This is the case in law firms, accounting firms, and all other professional service firms, apart from *pro bono* and "loss leader" engagements.

We do not believe in overcharging high net worth investors for such subsidies or delivering less service than they are entitled to.

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

Continue to permit embedded compensation for accounts up to $500,000, which could be tracked by the annuitant's social insurance number.

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

We believe that the unintended consequences of the proposal will be pervasive and negative. We do not believe that there are any measures available that could mitigate those consequences.

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?*

Fund companies would have to build the calculation, collection, and remittance functions.

Client may not be open to paying new fees.

- *What transition period would be appropriate?*

A 36-month transition period should be sufficient. We like a percentage staged approach for difficult-to-reach clients who lack incentives to change.

- *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?*

DSC and low-load schedules absolutely have to be maintained until the redemption schedule is completed. It is a loan repayment schedule that can't be shut off.

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

Options 1 and 2 could both work. We reiterate that this should only apply to accounts of $500,000 and up.

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?*

Yes. We believe that the CSA should reconsider its position with a view to caps being an ultimate solution rather than a transition option. A fee cap will level the playing field: if all equity funds offer the same DSC commission and the same trailing commission, compensation would not be a factor in advisors' fund recommendations.

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*

Yes. Disclosure is enough for investors to make sound choices. They should be able to choose to keep embedded compensation over direct pay, but embedded compensation could be limited to accounts under $500,000.

- *address or not address any additional harms or issues that you have identified.*

We have not identified any additional harms or issues.

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.

We do not agree with issues described in Part 2. We therefore do not believe that alternative options or measures are required to deal with them.

Concluding Comments and Observations

Now that we have addressed the questions posed by the CSA in Consultation Paper 81-408 we would like to bring your attention to our observations on the embedded Commission issue and some areas of concern.

There can be no doubt that **the majority of Canadian investors have expressed a desire to maintain choice** in how they pay for investment advice, financial, retirement, tax planning and risk management. The CSA has not clearly demonstrated why they feel that clients should no longer have a choice to pay for this advice through embedded commissions if they choose to do so. Further, clients have shown strong reluctance towards paying direct bill invoices for these services due to the unnecessary hassle factor, and may elect to skip paying for advice, thereby harming their ability to achieve their financial goals. And dealers and advisors are concerned about devoting their time on these services and risking the fact that their invoices go unpaid permanently, or they now have to operate a "collections department" to get paid for past services rendered. We draw these facts from actual investor interviews performed in very recent surveys by the Gandalf Group on behalf of AGF Investments, and by Blue Information Design Inc. and CRM2 Navigator on behalf of the Federation of Mutual Fund Dealers. In the UK RDR did not solve the obvious problems that they sought to fix. **The CSA should not be taking solutions to a problem in another country, and assume those solutions will work in our country, when we did not have those problems (such as the UK's pension pricing scandal, lack of transparency) in the first place.** The CSA paper acknowledges that while Sweden has serious concerns about the

potential conflicts with embedded commissions they chose to strike a balance instead of an outright ban on embedded commissions. New Zealand decided AGAINST a ban on commissions. Singapore did not ban commissions either. Why is it that the CSA does not appear to give these countries' decisions more recognition when driving the CSA agenda? In the PriceMetrix 5th Annual Report "The State of Retail Wealth", their research has shown that in North America not only has there been a record increase in the percentage of fee-based accounts, there has been an increase in pricing. Also, in the article titled "Advisers accused of overcharging post RDR", written by Julia Faurschou in FT Adviser March 16, 2017 a UK firm stated that "under the commission regime the annual ongoing amount paid to advisors by fund managers was often around 0.5 per cent, but since 2013 advisors have had to charge an explicit fee with many opting for around 1 per cent". That has effectively doubled from the commission regime era. **Preservation of embedded commissions at current levels would prevent such increased costs for retail investors from occurring in such funds.**

We do agree that something should be done where embedded commissions for advice are paid to dealers that do not offer such advice. Rather than try to level the playing field perhaps the CSA needs to finally recognize that there are two distinct playing fields in Canada – the Advice Field and the No Advice Field. The CSA should be focused on better investor outcomes over the long term, allowing Canadians to enter retirement comfortably with sufficient savings – and the stats prove that advised clients invest and accumulate much more wealth when they work with a financial advisor. This was taken directly from the Appendix in the CSA paper. Any savings realized by knocking down advice fees or buying lower cost ETFs instead of actively managed mutual funds will pale in comparison to what sound advice will deliver for investors. Non-advised clients tend to be savers through the use of GICs, savings accounts etc. which won't meet the needs of retirees in a 1% world. This type of non-advised, risk averse saving (not investing) is a huge win for deposit taking institutions but generally quite bad for most investors. Banning embedded commissions will support an already dominant vertically integrated bank model. And there is a definite risk that regulatory arbitrage will occur – some advisors will shift client assets to segregated funds that will still offer embedded commissions. Until the Insurance Industry and CSA get together on this at the very same time, the CSA needs to be recognizing this risk. **We propose that the CSA leave embedded commissions in the advice channel for accounts up to $500,000 in value, and eliminate embedded commissions from the no advice channel. We have no issues with eliminating embedded commissions on accounts over $500,000. At that account size a negotiated fee account is now a viable option for dealers, advisors, and clients alike.**

The CSA paper seems to be overly focused on investor fees for investment advice, and desired better than average performance (that in the CSA's view will be an automatic benefit as a result of reduced fees) in the absence of any discussion on the value received for the financial, retirement, tax, estate planning and risk management that is offered in the advice channel. The CSA does not seem to realize that the majority of the embedded commission pays more for the critical planning component, with very little being paid for the investment advice. This major gap in the CSA's understanding of what embedded commissions are for completely undermines the value of the paper. Put another way, the independent dealer community could, if they chose to do so, offer a "no advice" account at a similarly low cost to what Robo advisors or other Fintech providers charge – which seems to be the CSA's solution for everything. Fintech does not replace

valuable advice and it does not build trust or change bad investor behaviour. As an aside, when the Fair Dealing Model was tabled in January 2004 we had asked about offering an account solution for the Do It Yourself investor similar to what Bank Discount Brokers offer, with reduced compliance oversight and KYC update requirements. We were never given that opportunity to compete in this manner. The CSA repeatedly mentions the term “level playing field” but independent dealers are not even allowed on the field – to the delight of the bank owned dealers and discount brokers. The paper also makes vague references to potential conflicts of interest where volume based incentives may cause higher trailer fees to be paid to the advisor. I can tell you that in my thirty years as a licensed mutual fund salesperson I have never even heard of this being available from any mutual fund company, except perhaps at a captive distribution shop.

The CSA also seems to be very selective in the data that they refer to in support of the agenda to eliminate embedded commissions. They state that roughly 90% of mutual fund accounts are with banks and insurance companies, therefore the CSA does not acknowledge that an advice gap even exists. Is the CSA satisfied to have all investors end up at banks and insurance companies? The CSA has conveniently forgotten the results of the OSC’s mystery shopping exercise because the results don’t support the CSA’s argument in this paper. The research found that the mystery shoppers could not get any financial advisors to take their appointment when they declared investable assets of $25,000 and then $50,000. It wasn’t until they declared that they had $100,000 to invest that any financial advisors would agree to meet with them to review their planning needs and investment goals. So here are results that the CSA has in their possession but will ignore; this is not from a biased industry driven study. To further the CSA’s weak argument on the lack of an advice gap, they happily point to opinions of incredibly biased competitors to support this argument. The most egregious example of this is when the CSA points to the Robo advisor community and passive investment strategies as the solution to any possible advice gap. The CSA has completely missed the fact that there is very little to no advice provided by the Robo channel. Another example of selective messaging is when the CSA points to supportive comments from fee based Portfolio Management/Investment Counsel Firms. Of course, these groups will support a move to fee based relationships – it’s their business model. What the PMs and CSA fail to disclose is that the PM/IC firms often have minimum account requirements of $1 million or more, and sometimes $5 million. The vast majority of Canadian investors will never meet such minimum account size requirements, so why even mention these supportive comments when the average mutual fund dealer account is only $50,000 according to the newly released MFDA study. A further statement is made that mass market households do not own investment funds today so they would not be affected by a proposed discontinuance of embedded commissions. That is a misuse of data that shows the majority of investors are “savers” more than they are “investors”. Referring to the PriceMetrix 5th Annual Report again, the data shows that there was a reduction in the number of small households serviced by advisors. Similarly, advisors are targeting more attractive new clients (older clients who typically have higher assets and will yield more revenue). **The advice gap exists**.

Several CSA Members (OSC, ASC, BCSC at Regulatory Forums in particular) have repeatedly stated that they do not want to hear industry opinions or anecdotal evidence; they want fact based data. We draw the CSA’s attention to some outrageous opinions in this CSA paper that can’t possibly be supported by any data. For example, on page 87 the CSA states that Mutual fund

managers of funds that pay embedded commissions (trailers) may stop trying to outperform. It reads "investment fund managers will continue to be incented to compete for sales on the basis of the compensation they pay dealers, reducing the likelihood that they will compete on the basis of performance and skill – potentially disadvantaging skilled fund managers who do not pay higher than standard trailing commissions or who do not pay any trailing commissions". What rubbish! Where is the CSA's data to support this statement? Chronic underperformers just won't keep their job, whether the parent fundco pays trailers or not, and no advisor would risk losing a client relationship over an underperforming, unskilled manager. We are in this for the long term because it takes a lot of work to convince a client to work with us at the outset. They can leave us with a stroke of the pen and there is nothing that we can do to stop them from moving. On page 107 and 115 in the Appendix the CSA pulls a ten-year old research opinion and a Globe and Mail article from 2013 that basically state that mutual fund companies add price complexity through ever expanding fund series "to maintain consumer ignorance on prices". I would like to see the facts that this conclusion was based on. I believe it would be safe to say that the fund companies are expanding the number of series to offer volume based pricing to appease regulatory initiatives from two years ago and to avoid regulatory fines where clients may have been entitled to discounted pricing but did not receive such discounts.

Other statements in the paper that require fact based data are where the paper states that if you eliminate embedded commission funds entirely the number of mutual funds will drop from 13,899 to 4,901 - a 65% decline and the conclusion, which is really more of a wildly optimistic guess, is that this will lead to surviving funds becoming much larger in size, which will lead to lower investor costs. We are unaware of any data in any jurisdiction that will support this optimistic theory. Using domestic examples, until very recently, the largest of bank sponsored Dividend Mutual funds had an MER that was almost identical to other Dividend funds at a fraction of their size – no volume discounts here! A follow up point that is made on the next page of the paper is that this radical change will lead to new, low cost entrants. What is that based on? I believe that the CSA paper has taken a Vanguard Executive's comments in a CSA interview some years ago completely out of context. He was asked why Vanguard had not brought their low cost mutual funds to Canada previously. He replied that Vanguard does not pay "platform fees" so they did not think they would be successful here, nor had Canada embraced fee based F class accounts at the time. Such "platform fees" are illegal in Canada, yet the CSA did not seem to know that or just grabbed a supportive soundbite to support their goal of fostering more competition amongst low cost funds or new entrants. So, in effect, there was no such "barrier to entry" as the CSA has stated. Fee based or F class funds were not that prevalent at the time, so Vanguard made the business decision not to be one of the first to try to roll this out.

On page 59 a statement is made that passive portfolios outperform actively managed portfolios, but the time frame used was selective to support this statement, and shockingly the CSA makes no mention of volatility or standard deviation that we are required by regulation to pay strict attention to when assessing suitability and risk tolerance for our clients. Here is another gem in this paper: negative alpha funds will disappear or adapt by focusing more on performance! Again, I have been in this industry for thirty years and I have never seen a portfolio manager that was not focused on performance for a given level of risk.

Thank you for the opportunity to provide our comments. We would be pleased to discuss our comments further if the CSA have any questions on our comments or would like further clarification of them.

Yours truly,

"Mark Kent"

Mark S. Kent, CFA
President & CEO