British Columbia Securities Commission June 9th, 2017
Alberta Securities Commission
Financial and Consumer Affairs, Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorite des marches 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, Nunavit

Personal Submission by M. George Lewis re: CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions

Introduction

I want to first of all congratulate and thank the CSA for the time and care it has taken and is taking to study the option of discontinuing embedded commissions in the market for mutual fund and related products. Mutual funds in Canada represent the highest percentage of household financial assets (18%) of any country in the OECD data base. This contributed in my view to the strong annual growth rate in Canadians' financial assets of 5.8% cited in the Consultation Paper ("CP") from 2005-2015, a rate higher than in the U.S. (4.6%) despite higher equity market returns in the U.S. over the same period. The importance of mutual funds, and the access to the professional investment management delivered through them, to the financial well-being of Canadians and the efficiency of our capital markets, is considerable. In fact, it is much greater than in any other country that has experimented recently with the types of changes being contemplated in the CP. As someone who had the privilege of a leadership role in the mutual fund/asset management industry from 2000 until my retirement as Group Head of Wealth Management and Insurance for RBC in late 2015, I hope my personal submission will be of assistance at this late, deciding stage of your deliberations. While drawn from my experience at RBC, the following represents my personal views and not those of RBC.
The CP is an extensive yet very readable document which provides good insights into the current thinking of the project team/CSA. I recognize that the CSA has sought and received extensive input from current participants who are better positioned to respond to the questions posed in the CP. I also acknowledge the CSA's desire to receive stakeholders' analysis and perspectives that were not raised in prior consultations and that are "evidence-based, data centric and Canadian-focused". This is my first submission and I hope that my analysis and perspectives will be useful in the CSA's final "judgment" stage; they are definitely "evidence" and "data" from my experience leading RBC's asset management business from 2000-2008 and Global Wealth segment (which included RBC's asset management business) from 2007 until late 2015. I recognize that my comments will form part of the public record of the CSA's deliberations; the initiatives and perspectives shared no longer have current competitive value but hopefully will aid in your understanding of the historical development of the mutual fund market and, in particular, Canada's position as a global leader in the access of individual clients to professional investment management.

In addition to the roles described above, from 2012 I represented RBC's Insurance segment until my retirement from the Group Executive of RBC in November 2015, during which I gained perspective on the different environments for investment products in the separate regimes of insurance and securities regulation. Between 2004 to 2006 I had responsibility for all of RBC's banking product businesses, many of which (like our mutual fund business) faced significant competition from large, specialized global competitors including new entrants in the credit card business. Finally, earlier in my career I was an equity analyst covering the utilities, pipelines and telecom service industries, during a period when regulators were implementing competition in long-distance telephony and overseeing the beginnings of wireless services. The CP has many indications that the CSA is attempting to direct rather than regulate the industry, including predictions of (hoped-for) future industry developments (greater variety/complexity of advisory service models, growth of passive investment products, attraction of "disruptive" new entrants to the industry) if the recommendations in the CP are implemented. There may be useful lessons learned from other regulatory environments in this regard.

Review of RBC GAM

I believe it would be useful to provide a brief review of the key business initiatives and their outcomes by RBC Global Asset Management since 2000; many asset managers affiliated with deposit-takers/insurers have implemented similar moves and, where this is the case, I will highlight observations from the CP where these business initiatives have been significant contributors. The efforts described below, and the positive outcomes generated for investors, advisors and RBC GAM's business are the result of dedicated work by the employees of RBC GAM and their partners in serving clients.

1. **RBC GAM entry into non-branch channels/third-party funds made available to RBC branch financial planners (2000-2003 and onwards)**

Prior to the year 2000, RBC GAM focussed exclusively on the bank branch network of RBC (including financial planning teams) as partners to reach individual investors. This strategy was successful during a period of fast growth for the mutual fund industry overall in the 1990s as interest rates declined significantly. This approach resulted in RBC GAM achieving a market share of roughly 8 percent and becoming the third-largest mutual fund company in Canada at the time.
However, to sustain and improve its industry position, RBC GAM needed to compete in all channels of the mutual fund industry and, in particular, support the sales and servicing of our funds in the IIROC channel, the largest industry channel as detailed in the CP. At the same time, in order to improve the competitive positioning of RBC's financial planning teams (relationship managers in branch focussed on clients with greater than $100,000 in financial assets), individual third-party funds were made available to those teams and their clients. Portfolio solutions comprised of third-party funds were also made available to all clients of the branch network. From this time forward, RBC GAM was operating in a competitive environment across multiple channels.

2. **Market-based trailer-fee vs. Cost-recovery transfer pricing from RBC GAM to RBC branch channel (2000 onwards) – Investment in Branch Advice/Delivery by RBC**

Coincident with the separation of the mutual fund manager (RBC GAM and predecessor companies) and dealer (Royal Mutual Funds Inc. – "RMFI") activities at RBC, RBC GAM moved to market-based transfer pricing using the "trailer-fee" model, compensating all dealers (affiliated or otherwise) at the same level. This provided additional, and recurring, funding for RMFI's operations and the significant expansion of its sales-force and advice-giving capabilities. Similar moves by other deposit-takers/insurers were likely a large contributor to the high number of advisors per client in Canada cited in the CP, relative to other countries where access to advice and professional investment management is more limited.

3. **RBC GAM multi-channel, investor choice strategy – focus on no-load/trailer-fee model and series F in IIROC/third-party advisor channel (2000 onwards), launch of series D funds**

In addition to a strong focus on its primary partner (RMFI), RBC GAM significantly expanded its efforts with the IIROC/third-party advisory channel as well as non-advice/direct channels. The product series focus in the IIROC/advisory channel was primarily two-fold – series A (no-load funds with trailer fees) and series F (no-load funds with trailer fees excluded from the MER for use by advisors who charged their clients using fee-based accounts). Both models align the interests of asset managers, dealers and clients and the focus of RBC GAM on investment performance/process, product design and pricing and overall service proves this. On the other hand, it is questionable whether the DSC structure meets this test of alignment, as clients are "locked-in" via redemption penalties.

To attain the #1 market share position in the industry, RBC GAM needed to have competitive and tailored offerings for clients to access, no matter who they chose for advice, how they chose to pay for advice (bundled or unbundled) or if they were self-directed investors and didn't want to pay for advice. Accordingly, RBC GAM was the first asset manager to launch series D funds which carried a lower trailer fee (25bps) and were made available for clients of non-advice/self-directed dealers. Frankly, over ten years after their introduction I would have expected series D shares to make up a larger proportion of mutual fund holdings in self-directed platforms. The CP notes that the large proportion of series A (full advice trailer fee) funds held by clients on self-directed platforms indicates these clients may be providing a subsidy to these businesses (or a subsidy to other non-mutual fund clients of these businesses). See Recommendations below.

4. **Consistent low-fee positioning (2000 to present)**

RBC GAM has been a consistent leader in providing lower-MER funds in each series of funds, with over 90% of its fund MERs being below the industry average and, in many cases, significantly so. PH&N, acquired in 2008, had a similar low-fee positioning which has been maintained with both RBC Funds and PH&N funds offered across RBC GAM distribution partners. RBC GAM has continued to lower MERs periodically even where it is already a low-fee leader in the category.

5. **Investment in active management, performance measurement, ESG**

While RBC GAM offers an extensive range of index funds, ETFs, and funds based on purely quantitative strategies, the majority of its capabilities are delivered through actively managed funds. This has been the result of considerable internal expansion of teams in Canada, the U.S., the U.K and Asia, as well as significant acquisitions (roughly $1.5B each) of PH&N and Bluebay Asset Management. RBC GAM faces competition from other Canadian-based firms with strong domestic and global capabilities, as well as large U.S.-based global firms (Fidelity, Invesco and Franklin Templeton) with a significant share of the Canadian mutual fund market.

RBC GAM's enhanced capabilities have been incorporated into its portfolio solutions which are used by financial planners/advisors to align with clients' risk tolerance and return objectives and which, together with good performance and ongoing advice and service on the part of these planners/advisors, has resulted in a significant reduction in redemption rates (especially during periods of market stress) and better investor outcomes.

The performance of RBC GAM's mutual funds is measured internally against both a competitive actively-managed universe (all series) and relative to passive benchmarks (series F). Its portfolio managers are compensated based on this performance over various time-frames with an emphasis on the longer-term record. At least with respect to RBC GAM, and I suspect with other managers who rely on the no-load/trailer fee model (with daily redemption possible with no penalty for investors), the assertion in the CP that embedded compensation can lead asset managers to downplay the importance of investment performance is simply wrong. Again, I see the risk being more likely with DSC-based providers.

This focus on active investment management has gone hand-in-hand with significant efforts in exercising RBC GAM's role as owners, on behalf of its investing clients, of publicly traded corporations. RBC GAM was a founding member of the Canadian Coalition for Good Governance in 2004 and its Chief Investment Officer was the Chair of the organization for several years. As the CSA knows, the CCGG is a coalition of investment managers that focuses on working with public companies to improve performance through enhanced corporate governance, with positive outcomes recently documented in a University of Toronto (Rotman) study. RBC GAM was also the first mutual fund company to publicly disclose its proxy voting record and also established a senior executive role several years ago with responsibility for implementation of ESG policies throughout the firm. These and other activities of active investment managers contribute significantly to market efficiency, one of the objectives outlined in the CP, which makes passive investing options viable. See Recommendations below.

6. **Results:**
    a. **Investment awards/investor outcomes**

While it is difficult to generalize with respect to investor outcomes, a good proxy is investment performance of the overall fund group, especially as judged by quantitatively-oriented services such as Lipper Analytics, a division of Thomson Reuters. Since bringing their analysis to Canada in 2008, Lipper has identified the top-performing funds and overall fund families across the Canadian mutual fund industry. Over the last nine years of awards (2008-2016) RBC GAM (PH&N and/or RBC families) has been named best overall fund group in seven years and best overall bond fund group in all nine years.

b. **Lower redemption rates**

Since the early 200os, redemption rates of RBC GAM's long-term funds have fallen significantly (50-70%) and remained low, even during the 2008-2009 financial crisis. Investments in active management capabilities, growth in RBC bank's salesforce and advice-giving capability, and products better designed to meet client needs resulted in clients "staying in the market" to a much greater degree in 2008-2009 than was the case in the tech bubble of 2000. This resulted in significantly better client outcomes as markets recovered.

c. **Market share gains**

Taken together, these business initiatives by RBC GAM have resulted in an increase in market share from 8 percent in 2000 (third position) to 15 percent presently (first position). Roughly 3 percent was due to the acquisition of PH&N, with the balance being organic market share growth as a result of the initiatives detailed above. Other competitors with high performing/lower cost funds have also gained share, while those who have lost share have generally been among the higher cost fund families. This result is what would be expected in a competitively-functioning market delivering positive results to clients.

Recommendations

I have focussed my recommendations in line with the CSA's areas of encouragement for industry participants' business models (page 3 of the CP) along with the objective of at least maintaining the current level of access to advice in the Canadian market:

1. Having investor interests at their core
2. Aligning the benefits to investment fund managers, dealers and representatives with the benefits of clients
3. Making for more informed, engaged and empowered investors that expect and demand services aligned with the fees paid
4. Promoting fair, competitive and efficient capital markets and fostering confidence in our market

1. **Maintain no-load/embedded trailer fee model in existing channels/eliminate sale of DSC funds –** The no-load model meets all of the tests above, especially with the enhanced disclosure initiatives (CRM2, Fund Facts) which RBC GAM and other industry participants have actively supported. There seems to be an underlying concern in the CP that this model is both high cost and a barrier to new entrants which doesn't make logical sense. In any event, to the extent that the cost of advice embedded within the no-load model reflects the higher costs of a full-advice, "bricks and mortar" delivery model, there are already initiatives from new entrants and established players to address this potential opportunity. No additional "disruption" from the CSA is needed that would limit the range of customer choices without clear evidence that they are harmful. The research provided in the CP with respect to no-load funds doesn't meet that hurdle and is, in fact, at odds with the actual experience in the market which has seen investor-friendly, lower MER/no load firms, such as RBC GAM, gaining market share.

In the case of the DSC sales model, the CP and my own experience does make it clear that this model may not meet the CSA's tests. The compliance issues cited in the CP (e.g. customers unaware of redemption penalties) are telling. Fundamentally, if the industry is arguing (correctly in my view) that there have been significant improvements in the breadth and quality of investment advice available to Canadians over the last two decades then why do we need a product feature whose only historical benefit has been to "keep clients in the market"? Surely, the threat of a financial penalty is no longer required to have clients avoid doing the wrong thing at the wrong time (i.e. redeem at a market bottom). I would recommend a reasonable transition period as outlined the CP (36 months) during which sales would continue to be permitted but there should be no redemption penalties permitted after the Transition Date. This should limit the possibility of an "unintended outcome" such as a surge of sales activity in DSC funds prior to the Transition Date. Elimination of the DSC model, together with my second recommendation, should provide sufficient "disruption" to the market to accomplish the CSA's objectives, without limiting the availability of business models (no load funds) that continue to meet client needs and maximize access to advice in all regions of the country.

2. **Only allow F or D Series in DIY/Automated advice channel**

   While I agree with the CP's conclusion that it would be inappropriate to require mutual fund managers to offer all series of funds (i.e. series D funds for DIY investors/dealers), it would be appropriate to prohibit DIY dealers from carrying series A funds which include the full cost of physically-delivered personal advice through a trailer fee three to four times higher than the trailer fee embedded in series D funds (typically 25bp). The extent of the holding of series A funds within discount brokerages, over ten years after the introduction of series D funds, is surprising. Some of the series A funds may be held by clients of integrated firms who are receiving advice on these funds from other channels within the enterprise and are simply using the self-directed platform as their preferred "holding" platform for investments. In any event, it would not be unreasonable for the CSA to require self-directed brokerages to allow only series D or F funds on their platforms.

   Since automated advice channels are in their early stages of development and growth, both as stand-alone businesses and as part of the multiple options for investors offered by integrated firms, it would be reasonable for the CSA to restrict embedded compensation from the products offered in these channels where there is no physical delivery/meeting or one-on-one individual client/advisor relationship). Investor choices and preferences are still evolving in this space and, hence, clients would not be negatively disrupted. This would also create a "level-playing field" for both active and passive investment management solutions in the automated advice channel as performance comparisons for active investment management would not be burdened by the cost of embedded compensation for advice. Many of the current automated/light advice models have passive investment options as their primary or sole fulfillment option. It is vital for long-term market efficiency and effective corporate governance that the products of active investment managers - who contribute to market efficiency through the analysis and valuation of companies, and engagement with their boards and management teams as owners – be included and become over time the largest share of solutions in this channel as well.

3. **Don't establish "goals" of increased diversity of service business models, increased levels of passive investments, or significant new entrants as tests of policy success**.

   The CP expresses a clear view in favour of diversity of service models (one-time fees, hourly time-based charges, fees based on account level, itemized services, etc.) in an effort to better align investor needs and desires with the level and type of service and advice provided. This is an understandable goal but some of the excellent observations in the CP, especially concerning the "intangible" (but very real in my view) benefits of advice may make this difficult. Simplicity in terms of a business model (i.e. fees based on account size) is not necessarily a sign of misalignment between investors and their representatives and dealer firms. Similarly, I am not sure why decreasing product complexity (cited as an objective in the CP by eliminating fund series with embedded compensation) while increasing service model complexity will result in better outcomes for investors. Furthermore, increasing service model complexity would make regulatory compliance by MFDA/IIROC industry participants and the effective regulation of those participants more challenging.

   The CP also displays a clear preference for passive investment solutions, including projections of hoped-for increases in market share for these solutions if embedded commissions are eliminated. This seems to be based on an assumption that this will result in better investor returns when, in fact, the record is far from clear. The ability of active managers to outperform passive, indexed solutions varies by asset class, geographic market and, importantly, over time during periods of varying levels of market volatility. It is also important to ensure proper comparisons and the interpretation of results; actively managed series A funds, with the full-cost of advice embedded in their MER, will very rarely outperform passive index benchmarks with no costs of investing (either investment management or advice) included. (On the other hand, RBC GAM's series F funds, reflecting the cost of active investment management without advice fees, compare favourably with actual passive solutions.) The CP notes that only 8 percent of actively managed portfolio solutions outperformed their benchmarks without noting that, by definition, the comparable percentage for passive solutions would be zero percent as even passive solutions have costs to implement not included in the benchmark return. My point is that the CSA should not establish increasing the market share of passive investment solutions as a policy goal. If any model deserves a "regulatory preference" it would be active management due to its contribution to market efficiency noted above.

   Finally, the CP contains many expressions of hope that eliminating embedded compensation will attract sizable new entrants, large and small, to the mutual fund industry. Spurring innovation and competition is an appropriate objective to improve investor outcomes but, as the experience of RBC GAM detailed above illustrates, it doesn't depend on new entrants. The "siren song" of the new entrant is one familiar to regulators in many industries with a much higher degree of concentration than the Canadian mutual fund industry; just one more subsidy, just one more encumbrance on established competitors to "level the playing field", and the new entrant will deliver on the promise of competition and innovation.

Let’s be clear; the opportunity for a large global direct-to-consumer mutual fund provider to compete in the Canadian market has always existed. Other global monoline product providers (e.g. credit card companies) have established a presence in other areas of financial services in Canada through direct-to-client models. U.S.-based asset managers (Fidelity, Franklin Templeton, Invesco have established significant shares in the Canadian mutual fund industry, largely through advisors. Rather than being discouraged to enter by the embedded compensation model in mutual funds, it is more likely that large passive providers such as Vanguard and Blackrock have chosen to focus on ETF’s (versus mutual funds) due to the ability to leverage the in-place securities exchanges/IIROC dealer platforms, rather than having to build a “stand-alone” mutual fund platform.

4. **Avoid regulatory arbitrage.**
   I want to close by commending the CSA and the working teams for their focus on avoiding the potential for regulatory arbitrage between similar products. I agree with the recommendations to apply the same decision, whatever that may be, to structured products and the other products noted in the CP similar to mutual funds and would encourage the CSA to co-ordinate the timing of implementation of its decision with that of insurance regulators to ensure there is no ability for advisors to be compensated differently for similar products.

Conclusion

Thank you again for the opportunity to provide my thoughts and advice as you consider this important decision. Canadians enjoy levels of access to professionally-managed investment solutions that are unprecedented on a global scale, which has resulted in significantly better outcomes and returns than those available through fixed-rate term deposits/insurance contracts. Effective and committed industry participants and regulators have contributed to this result over many decades and I would encourage you, in your deliberations, to not take the breadth and quality of this access for granted. First, do no harm.

Yours Very Truly,

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