



Advancing Standards™

June 9, 2017

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
The 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

comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

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

The Portfolio Management Association of Canada (“**PMAC**”), through its Industry, Regulation & Tax Committee, is pleased to have the opportunity to provide comments on the Canadian Securities Administrators’ (“**CSA**”) Consultation Paper 81-408 – *Consultation on the Option of Discontinuing Embedded Commissions* (the “**Consultation**”). Capitalized terms used in this letter but not defined here have the same meaning given to them in the Consultation.

About PMAC and our approach to this Consultation

PMAC represents investment management firms registered to do business in Canada as portfolio managers. PMAC members encompass both large and small firms managing total assets in excess of \$1.5 trillion for institutional and private client portfolios¹. Even though PMAC represents firms registered to do business under National Instrument 31-103 – *Registration Requirements and Exemptions* (“**NI 31-103**”) as portfolio managers (“**PMs**”), as of 2016, over 65% of our members are also registered as investment fund managers (“**IFMs**”).

PMAC is cognizant that the Consultation and impact of any decision by the CSA to discontinue embedded commissions will affect various registration categories and business models to different degrees. Through data collected by PMAC in a 2017 survey, we noted that member firms are compensated for different services based on a wide variety of fee models, but that the most

¹ For more information about PMAC and our mandate, please visit our website at: www.portfoliomanagement.org.

prevalent compensation model is fees charged based on a percentage of an investor's assets under management.

For the purposes of this letter, PMAC's response is primarily focused on the implications that the Consultation may have for PMs, their business ecosystem, the securities they invest in, and their clients. Where we have received more general feedback on the Consultation we believe could be useful to the CSA from a practical or operational perspective, we have also included such information here.

Overview

PMAC advocates for the highest standard of unbiased portfolio management in the interest of the investors served by our members. In fact, that is PMAC's mission statement: advancing standards. For this reason, we are consistently supportive of measures that elevate standards in the industry, enhance transparency, improve investor protection and benefit the Canadian capital markets as a whole.

PMAC would like to thank the CSA for their work in drafting the Consultation as well as for mandating an extended comment period to allow stakeholders to gather data and ideas around alternative measures and/or the potential effects of discontinuing embedded commissions. Should the CSA determine as a result of the Consultation that discontinuing embedded commissions is the only way to sufficiently manage or mitigate the identified investor protection and market efficiency issues they believe arise through the use of embedded commissions, PMAC believes that the comments solicited under Part 4 - *Regulatory Impact* and Part 5 - *Mitigation Measures* of the Consultation will be critical for the CSA to carefully consider to ensure that measures are adopted to minimize disruption and to mitigate any negative impacts to investors, industry and our markets.

PMAC continues to support and champion the ongoing efforts of the CSA to identify opportunities to improve the investor-adviser relationship. We believe that the integrity of the client-registrant relationship is of crucial importance to confidence in the markets, a healthy economy and access to investment advice for all Canadians. We also believe that ensuring broad access to a variety of investment products and investment advice that is provided with the highest levels of integrity and skill is in the best interest of Canadians as a whole. We express our concern with any measures – or the manner of implementation thereof - that could either harm or hamper access to investment choice and advice.

SUMMARY OF PMAC'S KEY RECOMMENDATIONS

- 1.** Consider any new, alternative options to banning embedded commissions put forward to the CSA as a result of the Consultation that would address the CSA's investor protection and market efficiency concerns with a view to improving outcomes and minimizing the disruptive impact of any such change on investors and stakeholders.
- 2.** Review the feedback received as part of this Consultation in conjunction with the proposed changes to be implemented as a result of CSA Consultation Paper 33-404 – *Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients* ("**CSA 33-404**") as one way to assist in addressing certain investor protection concerns and alleviating the investor expectations gap identified by the CSA.
- 3.** Regardless of the determination made as a result of the Consultation, focus on bolstering investor education and outreach as a critical way to increase investor knowledge about the importance of investing, the benefits of advice, the nature of the various investor-registrant relationships, including the impact of dealer compensation on investment returns, and

products available to help Canadian households meet their savings and retirement goals. Change within the industry without corresponding outreach to investors in general runs the risk of disrupting business without achieving the CSA's goals of increased alignment between investors and dealers and of increased investor negotiating power and fee transparency.

4. Where possible, maintain as much investor choice as possible with respect to the ways in which investors can pay for advice. Where feasible, encourage the use of innovative regulatory initiatives and technologies for both online and traditional firms to address the risk of an advice gap. Streamline any regulatory action arising out of the Consultation, CSA 33-404 and any future "CRM3" amendments to minimize the impact of such changes on firms and to allow advisers to focus on servicing their clients.
5. Work strenuously to harmonize the regulation of compensation models across other applicable regulators to ensure that the possibility for regulatory arbitrage is minimized, especially if other products with embedded commissions continue to be available in other regulatory environments. We believe that a lack of harmonization will lead to regulatory arbitrage to the detriment of the CSA's goals in the Consultation.
6. If the CSA decides to discontinue embedded commissions, carefully consider feedback in respect of necessary technical, operational, client communication and other aspects required for stakeholders to effectively transition to the new requirements with minimal disruption. Aspects of such transitional planning include the need for FundServ's technology to operationalize the redemptions for investors' fees to avoid a very onerous manual process and to allow sufficient time for meaningful investor education by firms with respect to the nature of the redemptions for fees paid that will appear on their CRM2 reporting. Members anticipate that these redemptions, without proper education and messaging, may affect the performance reporting and confuse clients, resulting in an influx of investor calls.

Each of these recommendations and additional comments are discussed in turn below.

CONSULTATION QUESTIONS

Part 4: Regulatory Impact

Question 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?

It is our understanding that other commenters may have compiled research and suggestions around alternative options for consideration by the CSA that would address the CSA's investor protection and market efficiency concerns. To the extent that the CSA view any of these, including "CRM 3" reporting of management expense ratios ("**MERS**"), as being acceptable alternatives to banning embedded commissions and that such measures are anticipated not to have a disruptive impact on industry and investors, PMAC would be supportive of further consultation on such alternatives. Being cognizant that uncertainty is not good for any stakeholders, we encourage the CSA to make a considered determination as to whether to ban embedded compensation and to announce and implement a transition plan as soon, and as clearly, as possible to allow for necessary changes to be made.

We view the consultation undertaken in CSA 33-404 as being closely connected with addressing the investor protection and market efficiency concerns of the CSA with respect to embedded compensation. We were pleased to see that the CSA also views these two initiatives to be interrelated, as noted in [CSA Staff Notice 33-319 – Status Report on CSA Consultation Paper 33-404](#). Efforts by the CSA to address the investor expectations gap identified in CSA 33-404, through the implementation of certain targeted reforms relating to, among other issues, the management of conflicts of interest, may be helpful components in alleviating certain of the investor protection concerns outlined in this Consultation.

Canadians benefit from a world-renowned regulatory environment. We commend the CSA for their actions in creating and preserving this environment as well as for being committed to researching and implementing best practices in securities legislation from international organizations, such as IOSCO. PMAC believes that this Consultation provides an important opportunity for the CSA to continue this positive trend – regardless of the regulatory change that it determines is necessary to implement with respect to embedded fees – by leading the charge in encouraging collaboration between various industry stakeholders – be they CSA members, SROs, industry and thought-leaders in the field – to help to bolster investor confidence in our markets, advisers and the value of obtaining investment advice. Especially in a low interest rate environment and where many Canadians are not participating in the equity markets and do not have defined benefit pension plans upon which to rely, access to quality advice provided by highly qualified professionals is of increased importance in providing for reliable and adequate retirement savings. We see the investor protection and market efficiency issues raised by the CSA in the Consultation as being closely connected with the issues of investor trust, transparency and education.

PMAC has been a consistent advocate of greater transparency to assist investors with greater information about their options, including around costs, risks and features of various investment vehicles. We also continually support increased investor education and outreach as a critical way to increase investor knowledge about the importance of investing, the benefits of advice, the nature of the various investor-registrant relationships, including the impact of dealer compensation on investment returns, and products available to help Canadian households meet their savings and retirement goals. We believe that regulatory change is most impactful when accompanied by a corresponding public awareness campaign which can educate investors as to their options, negotiating power and the value of advice.

We commend various members of the CSA for their very accessible, clear and informative outreach on initiatives such as [fees](#), CRM2 reporting and [identifying fraud](#) and are of the view that more such campaigns are of essence in increasing the number of Canadians who access investment advice and who invest for their future.

Upon implementation of the regulatory amendments the CSA determines are necessary as a result of the Consultation, we see investor education and awareness as being a useful tool in combatting the risk of an advice gap as well as in informing investors of the various options that may exist in terms of paying for advice – whether this be through up-front payment, redemptions (and the tax implications thereof), embedded commissions, direct fees or otherwise.

PMAC views practical measures that bridge the gap between the often complex world of compensation structures and the sometimes opaque distinctions between types of purchase options and types of investment advice as being an essential component in any compensation reform the CSA intends to adopt. Some members noted that “CRM3” client reporting with disclosure of MERs and non-cash incentives may present one option for helping to inform clients of the total fees they pay for both products and advice.

PMAC does caution that, despite the importance of the feedback the CSA will receive through this Consultation, a focus solely on compensation models may do a disservice to investors and the industry in general by obscuring other, equally or more important, investor objectives. These

include having investment goals, retirement, financial and estate planning, as well as the importance of obtaining professional advice to help clients articulate and meet their goals. While the focus on fees is a timely one, we remind the CSA that a focus solely on this aspect of the registrant-investor relationship may not ultimately serve to encourage Canadians to seek professional investment advice for the benefit of their future savings. The regulatory focus on fees focus can also have the negative effect of commoditizing investment product and services and discouraging investor research and investigation to thoroughly understand investment services and products. In addition, embedded compensation is not the only conflict of interest situation that exists within the investor-registrant relationship, as we highlight in more detail below.

Change within the industry without corresponding outreach to investors in general runs the risk of disrupting business without achieving the CSA's goals of increased alignment between investors and dealers and of increased investor negotiating power and fee transparency.

We also see a role for regulators, governments and financial institutions in responsibly employing the tenets of behavioural economics to help Canadians understand the value of advice and the value of investing in our capital markets. We commend the [CSA for its work](#) to understand the impact this discipline can have on investor behavior and how Canadians go about seeking investment advice.

Members note that the advice they provide clients extends beyond helping clients invest for retirement and understanding different types of accounts. The value of advice also involves the very detailed and knowledgeable analysis undertaken by registrants in terms of knowing their clients and knowing their products in order to help clients meet their savings goals.

Question 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?

Members did not identify any other conflicts of interest that would be created by a transition to direct pay arrangements that would not already be addressed by securities law. Some members noted that an advantage of direct fee arrangements is the promotion of additional alignment of firm, registrant and client interests. While, generally, members agree that the direct fee model may carry with it the fewest inherent conflicts, they did note that the CSA's assumption that all conflicts of interest would be addressed by such a move may not be entirely accurate since conflicts can theoretically exist in any form of fee arrangement. That having been said, the duty of care owed by registrants to their investors under NI 31-103 and, additionally, the common law² duty owed by portfolio managers – means that there is and will continue to be an obligation on the registrant to disclose and manage all such conflicts. We see an important interaction between the CSA's concerns over conflicts of interest in this Consultation and the proposed targeted reforms in CSA 33-404. These targeted reforms would enhance conflicts of interest disclosure, management and avoidance obligations on registrants in a way that could further alleviate concerns over the impacts of such conflicts on investors, regardless of compensation structure.

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

Members did not feel positioned to opine on whether the proposal in the Consultation would lead to an advice gap but did note the advantages to preserving as much choice for investors as possible. Members have noted that several members of the CSA are leading the charge in enabling the

² And, in certain provinces, statutory, fiduciary duty.

registration of emerging business models. These regulatory initiatives may yield innovative, efficient and useful solutions for both online and traditional firms to help address the advice gap for lower wealth investors and/or to service Canadians who are not yet participating in our capital markets. PMAC urges the CSA to extend these helpful initiatives beyond the online space so that traditional firms can, where applicable, also harness these innovations for the benefit of their investors.

Members also stressed that any regulatory action arising out of the Consultation, CSA 33-404 and any future "CRM3" amendments should be as streamlined and coordinated as possible to minimize the impact of such changes on firms and to allow advisers to focus on servicing their clients. We commend the goal stated by the Ontario Securities Commission ("OSC") in its Statement of Priorities for the fiscal year ended 2018 in which the OSC prioritized the assessment of ways in which to reduce the regulatory burden while maintaining appropriate investor protection. We ask the CSA to view all proposed regulatory changes through this lens. PMAC supports the work of the CSA to fortify the registrant-investor relationship while ensuring that such measures are undertaken in such a way that minimizes disruption to industry as much as possible, while maximizing benefits to investors, being aware of the often significant systems, compliance, and other costs that are involved in changing business practices and of the extensive regulatory changes the investment management industry has already recently navigated.

Question 21 – ...What is the likelihood and magnitude of regulatory arbitrage across similar financial products such as segregated funds and deposit-taker products?

PMAC believes that harmonization of regulatory requirements and, in particular, compensation models, will be a critical aspect of ensuring that investors are aware of their options and the fees that they pay for certain types of investments and advice. Any non-harmonized outcome will exacerbate the confusion the CSA is concerned that investors face. Non-harmonization is also likely to also have adverse impacts on the operational and compliance departments of firms that provide advice. We urge the CSA to work closely with other regulators to ensure that the possibility for regulatory arbitrage is minimized, especially if other products with embedded commissions continue to be available in other regulatory environments - regardless of the route the CSA ultimately determines to take to address the concerns identified in the Consultation. Other jurisdictions have tried to address this prior to fee reform, most notably the UK. PMAC believes that failing to implement similar fee reforms across all regulated sectors could create a real risk of a significant number of investors being steered towards those products that carry embedded compensation.

Question 22 – What impact will the proposal have on back office service processes at the IFM or at the fund dealer? In particular, is there any specific operational or technological impact that we should take into consideration?

PMAC views this as a central question that the CSA should carefully consider in making its determination as to whether and/or how to discontinue embedded commissions. Members have identified the following operational and other considerations that would need to be appropriately addressed, updated and deployed in advance of any change in permissible compensation structures.

Technology / Systems

Members noted that, were IFMs to be required to process redemptions for investor fees, this would be an intensive, manual process to implement. We understand that FundServ is working on technology to operationalize this process and urge the CSA to consider the feasibility of coordinating the effective date of any regulatory change with the availability of appropriate technology to allow firms to seamlessly adopt such systems for the benefit of investors. Members believe that implementing manual processes and/or other systems changes needed prior to having

such technology available to them would increase the regulatory burden and operational risk without a corresponding benefit to investors.

Members noted that investor education – both from firms and the regulators – may be required so that clients will understand the nature of the redemptions for fees paid that will appear on their CRM2 reporting. Members anticipate that these redemptions, without proper education and messaging, may affect the performance reporting and confuse clients, resulting in an influx of investor calls.

We therefore ask that the CSA allow sufficient time for such changes to be made in advance of any implementation of regulatory amendments in this regard in order to minimize disruption to investors and stakeholders.

Concluding Comments

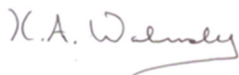
We would like to thank the CSA for all of the work, thought and outreach that has gone into developing and publishing this Consultation.

We do urge the CSA to carefully consider any feasible alternatives proposed that would serve to manage the investor protection and market efficiency concerns outlined in the Consultation. PMAC is strongly in favour of the CSA selecting one course of action through which to remedy or mitigate the perceived harms caused by the use of embedded commissions instead of adopting any stop-gap or temporary measures which would necessitate a series of operational, technological, communication, reporting, investment and other changes to the ways in which firms help their clients save for their future. It is our view that the industry has been tasked with implementing a vast number of changes over the past few years – many of which are positive but which have nonetheless necessitated the dedication of a great deal of business resources. Should the CSA determine to phase out the use of embedded commissions, we ask that such a transition be implemented with sufficient time to allow for all of the changes, technologies and requirements outlined in our letter - and those of other commenters - to take place with minimal negative impact on all stakeholders.

We would be happy to speak with you further about any of the remarks in our letter.

Sincerely,

PORTFOLIO MANAGEMENT ASSOCIATION OF CANADA



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