June 9, 2017

The Secretary
Ontario Securities Commission
20 Queen Street West,
19th Floor, Box 55
Toronto, Ontario
M5H 3S8
Submitted via email: comments@osc.gov.on.ca

RE: CSA Consultation Paper 81-408 - Consultation on the Option of Discontinuing Embedded Commissions

Worldsource Wealth Management Inc. thanks the CSA for the opportunity to provide comments on this paper and commends the CSA for the extensive due diligence in the area of Mutual Fund costs and Dealer/Advisor compensation that they have conducted to date.

There is however more to consider in both of these areas as we feel that discontinuing embedded compensation could:

1. Disadvantage Dealers that have not integrated Asset Management capabilities into their operations;
2. Increase Investor Costs; and
3. Reduce the availability of advice to lower net worth Canadians.

Additionally we would like to comment on the CSA's statement on page 14 of Consultation Paper 81-408 where they declare that "embedded commissions paid generally do not align with the services provided to investors".

We discuss each of these concerns below:

1. Before considering discontinuing embedded commissions attention must first be given to the reasons why embedded compensation, such as trailer fees, was created. "Trailer Fees, along

with deferred sales charges, came into being in the mid-1980s as fund companies who sold through Dealers responded to Dealers and sales people's complaints that they wanted to compete with no-load funds."[1] These no load funds were and continue to largely be sold by companies that had and have integrated their Dealer with their organization's asset management capabilities. In so doing they are able to charge investors management fees without directly compensating the Dealer. It should be noted that such relationships do not necessarily mean that cost savings are being passed down to investors, but rather similar compensation is flowed to the Dealer in the form of transfer pricing arrangements. The creation of embedded compensation increased competition, created alternate distribution channels and has helped to create a robust Canadian success story; one that according to the Conference Board of Canada estimates that the mutual fund industry in Canada directly employed 63,242 people and directly created $5.8 billion in real GDP to the Canadian economy in 2012.[2]

Any change to embedded compensation must also consider and address transfer pricing arrangements that exist within integrated financial service firms as well as ensuring the competitive landscape that exists today continues for both existing competitors as well as for new entrants. With respect to this point we feel that more work needs to be done.

2. While the introduction of embedded compensation has helped to create a level playing field amongst competitors it should be noted that it also resulted in lower investor costs. Before the introduction of embedded compensation such as trailer fees and deferred sales charges, the only compensation model available to clients was to pay an upfront commission charge which could be in excess of 9% of the amount(s) invested. In addition to this charge investors often paid a "switch fee" of 2% or more to move from one mutual fund to another. The creation of embedded compensation helped bring these costs down by providing another compensation model; one that favored investors and provided them with choice. While the CSA has outlined on page four of CSA Consultation Paper 81-408 that direct pay arrangements such as up front commissions could continue; one of the unintended consequences of discontinuing embedded commission could be increased investor costs. As a result, investors may in the future pay higher upfront commissions vs what they currently pay through embedded commissions. Research conducted by Strategic Insight in the United States supports this conclusion stating "in total, the unbundling of fees has resulted in an increase in the total shareholder costs for many mutual fund investors — with such increases amplified due to tax considerations at times. And a move

[1] Steven G Kelman 04/11/2015 Morningstar "Don't ban trailer Fees without all the facts: Regulators should make sure investors are getting their money's worth.

[2] The Conference Board of Canada briefing October 2013: Making Dollars and Sense of Canada's Mutual Fund Industry An Economic Impact Analysis

to unbundled fee-for-advice models has not resulted in a reduction of investor costs of mutual fund ownership[3]

We urge the CSA to fully investigate the impact on investor costs experienced by other countries that have moved to discontinue commissions and embedded compensation before introducing similar reforms in Canada.

3. Thus far one of the central concerns voiced by the mutual fund industry on the topic of discontinuing embedded compensation is that lower net worth Canadians would have reduced access to financial advice. To this end the OSC in their April 11, 2017 webinar indicated that they were unclear why this would be when a direct pay fee based arrangement could simply replace the trailer fee that is currently being received from the investment fund. While this comment is essentially correct (for higher net worth investors), one must also assume that the absence of embedded compensation would also increase the purchase costs borne by lower net worth Canadian investors. To this end consideration must also be given to the past and why trailer fees were created. “Trailer fees were the mutual fund industry’s answer to the persistent and wealth destructing switching that occurs when investors are left entirely to their own devices or, worse still when the only source of compensation for their advisors is commission derived from making a mutual fund switch. Trailer fees created the perfect alignment of advisor incentives with investors best interests.”[4] This view was also supported by Glorianne Stromberg in her 1995 report “Regulatory strategies for the mid-90’s: Recommendations for Regulating Investment Funds in Canada” where she wrote, “ Part of my reluctance simply to recommend that trailer or service fees be banned relates to the concern expressed by industry participants that banning these fees would just encourage sales representatives to increase the transactions within their clients’ accounts or to abandon their clients after the initial sale. There is concern that even with enhancing the supervisory controls and procedures; it is unrealistic to think that the measures will be sufficient to prevent switching and churning of accounts.”

   The MFDA has also recently commented on this issue with respect to the use of funds that carry a DSC load charge and found that “advisors may be using the embedded DSC commission paid by the fund company upon purchase to finance the cost of offering advisory services to mass market clients (defined as those with Financial wealth of less than $100,000). If so, a ban of embedded compensation would eliminate the DSC commission and may result in advisors having to charge clients an upfront fee to cover the cost of their services. As mass market households are less likely to be able to afford direct pay arrangements and are less likely to be eligible for fee based programs, they would be the most impacted by a ban of embedded

[3] Investor Economics, “Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios: A Canadian-U.S. Perspective, 2015 Update” (The Investment Funds Institute of Canada, 2015),
[4] Brendan T. N. Caldwell. 06/17/2013 The Financial Post; In praise of mutual fund trailers

compensation."[5] This was seen "in the U.K., after the decision was made to unbundle fees, the opening of investment accounts worth less than 100,000 pounds fell by half. After Australia required fees to be unbundled, there was a similar effect."[6]

As a result additional increased upfront and continuing commission costs could also cause smaller investors to have less savings and even worse cause them to save in potentially lower returning products such as traditional deposit products. Research indicates that "Canadian households using a financial adviser to assist in saving and investment matters and plan their retirement accumulated 1.58 times as much wealth as did non-advised households after four to six years; after 15 years, that had increased to 2.73 times. [7]

The Advisor Client relationship model is complex and extends beyond the recommendation of securities and the rate of return that those securities may generate. It encompasses activities such as:

- The initial and ongoing assessment of investors risk tolerance, investment objectives and time horizon;
- An assessment of their immediate and future income requirements;
- Advice and implications on withdrawal strategies and their income tax implications;
- Advice on asset location (the use of different investment account types);
- Immediate and ongoing assessments of the progress made towards their financial goals;
- Implementing savings strategies;
- Recommending and implementing investment strategies and rebalancing on an ongoing basis; and
- Behavioral coaching and helping investors navigate difficult personal circumstances such as job loss or divorce as well as difficult investment environments.
- In addition the Dealers role in the client relationship model is also important as they provide among other things:
    - Access to online information;
    - Transaction confirmations;
    - Quarterly reporting;
    - Annual Tax reporting;
    - Performance reporting;

[5] May 2017 MFDA Client Research Report A detailed look into Members, Advisors, Clients
[6] Peirre Lortie; University of Calgary School of Public Policy: A MAJOR SETBACK FOR RETIREMENT SAVINGS: CHANGING HOW FINANCIAL ADVISERS ARE COMPENSATED COULD HURT LESS-THAN WEALTHY INVESTORS MOST April,2016
[7] Peirre Lortie; University of Calgary School of Public Policy: A MAJOR SETBACK FOR RETIREMENT SAVINGS: CHANGING HOW FINANCIAL ADVISERS ARE COMPENSATED COULD HURT LESS-THAN WEALTHY INVESTORS MOST April,2016

- Compensation reporting;
- Two Tiers of Compliance Oversight; and
- Access to Financial markets and investment products.

While studies have been conducted that suggest Advisors add approximately 3% of Alpha[8] (additional Return) to the client relationship, the best source of investor satisfaction with Advisors services needs to be gleaned from their clients. To this end, time and time again investor surveys express client satisfaction with their Advisors. However, a recent survey conducted by the Gandalf Group between April 7th and May 5th 2017 is perhaps one of the most telling as this survey was conducted after investors had a chance to review their first Dealer Compensation and Performance Reports. This report concluded that: “there is little dissatisfaction with the current system of financial advice in Canada and the way advisor compensation is calculated. While there may be some dissatisfaction about fees, generally, there is relatively higher satisfaction when it comes to advisors transparency around fees.”

The acceptability about the current fee models relates partly to investor’s preference for a commission-based approach to advisor compensation based on portfolio value instead of a fee-for-service approach that would see investors invoiced with a bill they would have to pay out of pocket. While investors see value to fees geared to the amount and levels of service provided, and generally agree that fees should be negotiated, investors see strengths in both approaches. In a forced choice, more opted for a system of commissions paid by fund providers and financial institutions to advisors from the capital of the investments purchased with the advisor.” [9]

The value of advice provided by Advisors is not easily quantified. For instance each of the Advisor activities (and more) listed above as well as the services provided by Dealers must be included as part of the value that clients receive from Advisors throughout the engagement and relationship process.

In conclusion while the CSA is currently consulting on discontinuing embedded commissions, recognition needs to be given to how compensation models have evolved since the introduction of embedded compensation. Not long ago Advisor’s relied heavily on large up front and switch fees before transitioning to back end commissions as their primary revenue stream. The last decade has seen the transition to the zero commission front end load model and the subsequent increase in recurring revenue through the higher trailer fee associated with front end load funds. Over the past two years our Mutual Fund Advisors and their clients have begun to transition to the fee for service model. As a result, today more than 13% of every new dollar that is invested with our Mutual Fund Dealership Worldsource Financial Management Inc. is through a fee based solution. Five years ago that number was just 2%. Both of these trends are also significantly higher at our Securities Dealership Worldsource Securities Inc. We believe that these trends will continue without further implementation of regulation.

[8] Vanguard March 2014: Putting a value on your value: Quantifying Vanguard Advisor's Alpha
[9] The Gandalf Group, May 30, 2017: The Canadian Investor’s Survey: An Opinion Research Study in Fees & Advisory Services

One of the reasons for this belief is the continued introduction of new competitors and technology into the Canadian market. An example is Robo-Advisors some of whom now even provide advice. However, even Robo-Advisors with their sophisticated technology platforms are not without their challenges as “the average cost incurred by a U.S. Robo-Advisor to acquire a client is roughly $350 which covers such items as digital advertising and mass mail notifications. Given that the average fee in the US Robo-Advisory space is about 25 basis points, and the average account balance is $35,000, it takes them four years to just recoup their acquisition costs, and we're not even talking about additional operational overhead expenses on top of that." [10] This cost of client acquisition and account opening is also one of the main reasons that Canadian Dealers have higher account minimums on fee based advisory accounts as Dealers must marry account minimums with the expected revenue generated from their accounts. While to our knowledge the cost of client acquisition is not available in Canada it is fair to assume that it is significantly more than that experienced by US Robo-Advisors. Note that in our view the cost of client acquisition also supports the notion that lower net worth investors will not continue to have the same choice available to them as higher net worth Canadians with the discontinuance of embedded commissions.

CSA consultation paper 81-408 also:

- Expresses concern about the lack of new foreign entrants to Canada’s financial services landscape. We are of the opinion that, the cost of embedded commissions is not the reason for what has become a largely Canadian owned industry; rather the main barriers to entry of foreign financial firms are largely the result of the fact that the distribution of financial wealth in Canada is concentrated (approximately 60%) in the hands of a handful of organizations. Additionally “Compared to the U.S., Canada is a relatively more complex market with two official languages, two legal systems, 13 securities regulators and fragmented regulatory bodies which are currently different for each province. As interviewees’ expressed, these complexities become daunting to foreigners, especially U.S. - based ones and the cost of entry becomes significant relative to the opportunity to build significant share.” [11]

- Suggests that embedded commissions incent investment fund managers to rely more on payments to Dealers than on the generation of performance to gather and preserve assets under management. While mutual fund sales activities are regulated under “NI 81-105 Mutual Fund Sales Practices” our research indicates that in most cases, the portfolio managers that are employed by investment managers are paid a base salary and receive a bonus based on their performance, either relative to their Funds benchmark or to their peer group. In many cases, this bonus is paid on their Funds rolling one, three, and five-year periods, providing incentive to deliver strong long-term returns for investors. In other cases, portfolio managers are required to invest a substantial portion of their investible assets in the Funds they manage, to ensure they

[10] Tracey Lemay November 2015 Investment Executive DAC2015 Robo-advisors face challenges
[11] Strategic Insight Fee-based Report –Canada Winter 2017

are “on the same side” as their investors. Note that we have also seen several instances where any bonuses received by the portfolio managers are required to be invested in the funds they manage, and will not be accessible for a period of time, in some cases, as long as five-years out.

Evaluating the cost associated with investing is an important one. However, ultimately it must be investors who decide the distribution channel they deal with, the price that they are willing to pay for advice and the best method for them to pay for that advice. We believe that the CSA proposal will have a serious impact on wealth generation for Canadians. Embedded fees support a broad range of products and services for investors. Evidence from similar regulations in the UK and Australia suggests unbundling these fees led to increased financial advisor attrition and fewer financial services available to the average, mass-market investor (who didn’t meet asset thresholds). Both these outcomes represent the loss of sound, professional advice to the very people who needed it most.

We feel that regulation should encourage choice and apply equally to all Dealer and Investment Fund Management platforms.