The Intended Consequences of Embedded Commissions in Mutual Funds

In September of 2018 the CSA will conduct yet another consultation on the issue of embedded commissions in the mutual fund industry. Despite a decade's worth of consultations, written commentaries, meetings with various mutual fund stakeholders, politicians and consumer advocates and participations in numerous conferences and in roundtable discussions, the CSA and its provincial counterparts (collectively referred to herein as the CSA) still do not believe that they are properly informed about the issues surrounding embedded commissions – why else would they feel the need to embark upon yet another consultation on this issue? The CSA is right – it is clear to any observer that the CSA is not properly informed about embedded commissions. Further, by virtue of their lack of being informed, the CSA is in no position to carry out its duties and responsibilities as a regulator on this particular issue (where are our elected politicians?). Additionally, the CSA has, for reasons which appear inexplicable to those outside of the CSA, demonstrated time and time again that they are unwilling or unable to enforce existing laws, rules and regulations which, if enforced, would have ended the practice of embedded commissions in the mutual fund industry long ago. Ending this practice could have saved Canadian investors tens of billions of dollars of their life's savings which, not surprisingly and by design, ended up in the pockets of mutual fund industry players.

The CSA refuses to ask the right questions in its consultations and remains wilfully blind to a simple fact which supersedes any discussion on embedded commissions – and that fact is:

Withdrawals of monies by mutual fund managers/trustees from mutual fund trusts subsequently used as embedded commission payments to dealers are unlawful and contrary to various provincial securities laws and National Instruments.

The CSA knows, or ought to know by virtue of its position as an industry regulator, that any representations by any party that links trailing commissions (a.k.a. embedded commissions) to "services and advice" dealers allegedly provide to mutual fund unitholders (a.k.a. mutual fund trust beneficiaries) constitutes a negligent misrepresentation at best and a fraudulent misrepresentation if it is made by a mutual fund manager/trustee ("Trustee") or a dealer. To be clear, when a Trustee states (and they all do) in their Series "A" Fund Facts documents that trailing commissions are, "for the services and advice that your representative and his or her firm provide to you, "your Trustee has, in mandatory disclosure documents, engaged in a lie that it knows to be a lie (a fraudulent representation). To be even clearer, this fraudulent

misrepresentation is relevant to all mutual fund trust beneficiaries irrespective of the mutual fund distribution channel. The first and most glaring proof (and there are many more such proofs set out later in this letter) that Trustees and dealers have engaged in fraudulent misrepresentations can be found overtly in Distribution Contracts that exist between the two parties. A sample of such a contract can be found in Exhibit "A" attached (a copy of a Distribution Contract between TD Asset Management Inc. and TD Investor Services Inc.). As can be seen in the terms of paragraph 13 of this agreement, the dealer (TD Investor Services Inc.) receives trailing commission payments from the Trustee (TD Asset Management Inc.) as compensation for the services the dealer provides **TO** the Trustee. In this example, which serves as the norm for the mutual fund industry, the dealer is not required to provide any "services and advice" to unitholders in order to earn its receipt of trailing commissions. On the contrary, the unitholder is not even mentioned in this Distribution Contract and the Trustee, in concert with the dealer, has agreed that the true beneficiary of the dealer's services is the Trustee. In effect, the Trustee uses unitholder's monies to obtain benefits for itself not for its unitholders. The CSA knows, or ought to know this inconvenient truth - **embedded commissions in the mutual fund industry are built on a foundation of fraudulent and negligent misrepresentations.** Again, and to be clear, the negligent representations surrounding this false linkage of trailing commissions to "service and advice" are made by marketers, sales people and others who serve as an ill-informed echo chamber to the Trustees (and dealers) fraudulent representations. Does the CSA truthfully believe that these serious misrepresentations should be ignored in a discussion on whether embedded commissions in the mutual fund industry should be allowed to continue? Why has the CSA not broached this subject in any of its consultation papers?

SERVICES AND ADVICE

The CSA also knows that Trustees, in mandatory disclosure documents, have made the choice not to define the term "services and advice" in any of their mutual fund related documents despite knowing that this term is material and central to the Trustees cumulative withdrawal of nearly $8.0 billion of beneficiaries monies each and every year from Series "A" mutual fund trusts. Any discussions involving embedded commissions must be made with a clear, concise, unambiguous and cited definition of this material term. The CSA has failed at all times to include such a definition in any of their materials making any consultation paper, and any commentary on that paper, irrelevant and ill-informed. Upon inquiry as to where unitholders can find a definition for the term "services and advice" as found on Fund Facts documents, Ontario Securities Commission lawyers, on behalf of the CSA, have provided, in writing, their position. The CSA writes, "The dealer, as part of their relationship with the client, can explain the scope of the advice and services they will provide to the client in exchange for trailing commission compensation." In effect, the CSA is taking the position that the dealer, who did

not make the representation to the unitholder that linked trailing commissions to "service and advice" and who was not a party to the agreements that binds the unitholder and the Trustee in a mutual fund unit purchase, is somehow the legal entity that has the authority to define what the Trustee meant when he/she made the "service and advice" representation – this position is absurd on its face. Further, the CSA's writings appear to absolve the Trustees from any legal obligations to ensure themselves that their representations were/are at all times true and that their beneficiaries were, at all times, in fact receiving valuable "services and advice" from their dealers before the Trustee(s) made trailing commission payments to those dealers – again, this rationale is absurd on its face. The CSA, quite surprisingly, has it all wrong. Factually, it is the Trustees who are accountable to their unitholders for representations that they themselves made. Factually, the only parties that have a right to define a material term in an agreement are the parties that are party to that agreement (in the case of a mutual fund unit purchase, the Trustee and/or the unitholder). The CSA is a regulator who does not understand these basic contract principles?

<u>The CSA also knows the following which, in concert, provide support for the allegations of fraudulent misrepresentation by the Trustees</u>:

1) There is no correlation between the sum of trailing commission payments made on behalf of a unitholder by a Trustee and the cost or value of any alleged "services and advice" provided to that unitholder by a dealer. Provided that a Trustee and his/her unitholders could come to an agreement on what is meant by "services and advice", it is clear that some unitholders would be overpaying for the level of "service and advice" while others would be underpaying as the Trustee is paying trailing commissions based on the value of unit holdings irrespective of the level of "service and advice" ; and
2) Unitholders of Series "A" mutual funds who hold those funds in discount brokerage accounts are not offered and do not receive any advice or any advice related services from their dealer (such as estate planning, tax planning, buy and sell recommendations, etc.). Despite this fact, discount brokerages are compensated as if they are providing their clients with the same level of "services and advice" as their full service brethren; and
3) The vast majority of mutual fund unitholders do not fully understand how embedded commission payments are calculated, what embedded commissions actually are and who is the ultimate recipient of those payments; as such, no mutual fund unitholders can assess whether they received "services and advice" at all yet alone "services and advice" of a value that is equal to the trailing commission paid on their behalf; and
4) Non-mutual fund holding clients (who are not associated with the payment of a trailing commission) of a dealer receive the same level of "services and advice" as mutual fund

holding clients (who are associated with trailing commissions) of that same dealer, so what are trailing commissions actually used for? and

5) Dealers co-mingle trailing commission monies with other forms of revenue they receive. As such, trailing commission monies are used by dealers for a whole host of expenditures that have nothing to do with "services and advice" provided to a unitholder. That is, dealers may provide a portion of trailing commission monies they receive to their affiliates and/or their parent company (as an example Scotia ITRADE may provide trailing commission monies it receives to The Bank of Nova Scotia). These trailing commission monies may in turn be used by the dealer's affiliates and/or parent company for executive compensation and bonuses, profits, shareholder distributions, travel, marketing and advertising of non-mutual fund related products, loan capital, investment capital, etc. Dealers may choose to use a portion of trailing commission monies for their own executive compensation and bonuses, non-mutual fund related expenses such as legal expenses, regulatory expenses, the purchasing of cleaning products and toiletries, etc. None of the aforementioned uses of trailing commission monies would, according to any reasonable person, be described as being "services and advice" provided to unitholders; and
6) Trustees and dealers have engaged in practices that contravene numerous sections of both provincial securities laws and national instruments where such laws relate to prospectus representations and approved uses of trailing commission monies; and
7) Trustees are routinely violating their fiduciary duties, as confirmed by the terms of their respective declarations of trust and by trust law in general, each and every time they remove monies from a mutual fund trust with a total indifference as to whether those trust monies provide beneficiaries with anything of value.

The intended consequences of the status quo in embedded commissions are that mutual fund industry players enrich themselves at the expense of ordinary Canadians by actively concealing their abuses of power and breaches of the law. The CSA knows that embedded commissions in the mutual fund industry are carried out in an unlawful fashion under contract law, the law of torts, trust laws and securities laws. By virtue of being unlawful the CSA must take the steps necessary to end the practice of embedded commissions in mutual funds immediately. Further consultations on this issue are pointless and merely serve to distract from the plain and obvious fact that the CSA, elected politicians, industry related self-regulating organizations and yes, even the public, have dropped the ball and naively allowed the mutual fund industry to flourish by engaging in unlawful, immoral and harmful acts for decades.

Truly,

Dr. Gary Stenzler