THE INVESTMENT FUNDS INSTITUTE OF CANADA
L'INSTITUT DES FONDS D'INVESTISSEMENT DU CANADA

IFIC Submission

Mutual Fund Fees

Proposed Amendments to National Instrument 81-105 Mutual Fund Sales Practices and Related Consequential Amendments

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December 12, 2018

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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 of New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

Attention:
The Secretary
Ontario Securities Commission
20 Queen Street West
22nd Floor
Toronto, Ontario M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, rue du Square-Victoria, 22e étage
C.P. 246, tour de la Bourse
Montreal (Quebec) H4Z 1G3

Dear Sirs and Mesdames:

RE: Proposed Amendments to National Instrument 81-105 *Mutual Fund Sales Practices* and Related Consequential Amendments

Introduction

The Investment Funds Institute of Canada (IFIC) appreciates the opportunity to comment on the proposed amendments to National Instrument 81-105 *Mutual Fund Sales Practices* and Related Consequential Amendments (the **Proposals**).

IFIC is the voice of Canada's investment funds industry. IFIC brings together 150 organizations, including fund managers, distributors and industry service organizations to foster a strong, stable investment sector where investors can realize their financial goals. The investment funds industry has a long-standing history of supporting measures to enhance investor protection and increase transparency in the adviser-client relationship while continuing to preserve investor choice.

IFIC appreciates the CSA's rigorous consultation on the option of discontinuing embedded commissions. We are encouraged by the CSA's willingness to consider the potential impacts of changes to the embedded commission structure currently in place on both investors and market participants.

As the voice of Canada's investment funds industry, IFIC continues to support preservation of choice for investors. We believe it is important to preserve choice in the payment options available to investors for the advice and services they receive. We believe that:

1. The deferred sales charge payment option (the **DSC option**) continues to be an appropriate payment option for certain investors and should not be prohibited; and

2. Investors should continue to have choice in how they obtain investment services and should pay for the services they receive.

The DSC Proposal

The Proposals will repeal section 3.1 of National Instrument 81-105 *Mutual Fund Sales Practices* (**NI 81-105**), which currently permits fund organizations to pay upfront sales commissions to participating dealers for the distribution of mutual fund securities. The result is a prohibition on the payment of upfront sales commissions and the discontinuance of all forms of the DSC option (the **DSC Proposal**).

IFIC believes there is a role for the DSC option for certain investors and certain types of investment strategies. Investors with small amounts to invest on a regular basis who want personalized investment advice continue to be well served by the DSC option. It enables investors to put all of their money to work right away. Paying a fee on a monthly contribution of $25.00, for example, is simply not economical for these smaller investors. It would be an unusual regulatory outcome to make it more costly for smaller investors to invest on a regular basis.

The payment of upfront sales commissions by the investment fund manager to the participating dealer for the distribution of its mutual funds is a conflict of interest; however all compensation arrangements raise varying degrees of conflict of interest. Where a DSC option is suitable for the client, we believe the conflicts are properly managed through disclosure, supervision and compliance reviews. The CSA's Client Relationship Model amendments enhanced the transparency of the DSC option by mandating pre-sale disclosure of the deferred sales charges and redemption schedule.[1] The second phase of the Client Relationship Model amendments further enhanced the transparency of the DSC option by requiring account statements to indicate which securities in a client's account might be subject to a deferred sales charge if they are sold. This provides investors with an ongoing reminder of the applicability of the deferred sales charge to their holdings.[2]

In our view, the regulatory concerns related to the DSC option arise from the suitability of the investment recommendation rather than the DSC option itself. Firms that make the DSC option available to clients must consider the investor's time horizon, age and liquidity needs. In addition to managing conflicts, participating dealers supervise compliance with their policies and procedures related to the use of the DSC option. The adoption of specific best practices, including those set out in MFDA Bulletin #0670-C, is part of a registrant's continual review and assessment of the effectiveness of its compliance program. Regulators, in turn, must continue to enforce compliance with the supervision, suitability and disclosure obligations where registrants fail to comply[3].

The proposed Client Focused Reforms, particularly the enhanced conflicts of interest obligations as they relate to third-party compensation, will, if adopted, further enhance the

[1] NI 31-103, Section 14.2.1(1)(b)

[2] NI 31-103, Section 14.14(5)(g) and Section 14.14.1(2)(h)

[3] See footnote 24 of CSA Staff Notice 81-330 *Status Report on Consultation on Embedded Commissions and Next Steps* referencing MFDA enforcement actions.

existing framework for addressing conflicts of interest in product shelf development and in recommendations to clients to purchase a fund using the DSC option.

Under the DSC option, investors have the ability to switch out of a fund to another fund within the same fund family without being subject to any redemption fees. This enables investors to change their asset allocation or to switch from a poorly performing fund. While we acknowledge that the payment of a redemption fee may deter an investor from redeeming the entire investment before the redemption schedule has run out, in addition to the switch feature, investors can redeem 10% of their investment annually with no redemption fee. A similar concern arises in the context of redeeming certain non-securities financial products, such as a guaranteed investment certificate, before the maturity date. Furthermore, the potential payment of a redemption fee can have the positive effects of discouraging "short-termism" in investing[4] and impulsive responses to market volatility.

Finally, we note that a significant amount of segregated funds are sold using a DSC option. We are concerned that the DSC Proposal will create further opportunities for regulatory arbitrage in the investment industry and erode current efforts to level the playing field between mutual funds and segregated funds. Investment recommendations should be made based on suitability factors without being impacted by structural arbitrage which may make advice more accessible for smaller investors through non-securities financial products. We believe preserving the DSC option for mutual fund securities will preserve choice for investors.

Recommendation: IFIC recommends that the CSA continue to permit the sale of funds using the DSC option where it is suitable for a client.

The OEO Proposal

The Proposals will add a new subsection 3.2(4) to NI 81-105 that will prohibit fund organizations from paying trailing commissions where the participating dealer is not required to make a suitability determination in connection with a client's purchase and ongoing ownership of mutual fund securities (the **OEO Proposal**). Subsection 2.2(2) of NI 81-105 imposes a corresponding restriction on participating dealers soliciting and accepting any payment from fund organizations that fund organizations are not expressly permitted to make under Parts 3 and 5 of NI 81-105.

In a May 8, 2017 news release, IFIC noted "IFIC members believe that consumers should be able to choose for themselves the products, services and payment methods that best meet their needs and preferences" while ensuring that fees are aligned with the services that investors receive[5]. In this regard, we note that trailing commissions generally pay for four types of services: (1) trading and access to capital markets; (2) trading support; (3) advice; and (4) investor protection through robust compliance programs. Certain of these costs are common to all distribution models and are not strictly related to advice, including technology that supports the investment services, client reporting costs, custody and safe-keeping costs and the costs of registered representatives to assist clients.

IFIC continues to believe investors should have choice in how they access investment services. Investors should pay for the investment services they receive and registrants, in turn, should have flexibility in how they are compensated for the services they provide.

Recommendation: Investors should have choice in how they access investment services, investors should pay for the services received and registrants should have flexibility in how they are compensated for the services provided.

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[4] We use this term to refer to an excessive focus on short-term results at the expense of long-term performance outcomes.

[5] See https://www.ific.ca/en/news/limit-series-a-sales-to-channels-that-permit-advice-ific/

We now turn our attention to the introduction of a prohibition on investment fund managers paying a trailing commission where no suitability determination is made. Under the existing regulatory framework, the investment fund manager is responsible for the offering of the mutual fund. The investment fund manager must provide full, true and plain disclosure in the offering documents of the mutual fund. Placing a prohibition on investment fund managers is inconsistent with their obligations under the current regulatory framework.

As we note in our response to Question 6 it is also not effective to place this obligation on investment fund managers. The investment fund manager represents the reporting issuer. It does not have a direct relationship with the end client and has no visibility into the nature of the relationship between the participating dealer and the client. Therefore, any responsibility for determining which series is appropriate to make available to investors cannot reside with the investment fund manager. This approach creates consistency with the existing regulatory framework regarding the obligations of a reporting issuer.

Recommendation: IFIC recommends that the CSA remove the prohibition on investment fund managers paying a trailing commission to a participating dealer who does not make a suitability determination. Instead, the rule should prohibit participating dealers who do not make a suitability determination from soliciting or receiving payment for advice they do not provide.

Proposal Questions

In Appendix A we provide our responses to certain questions set out in the Proposals.

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IFIC appreciates the opportunity to comment on the Proposals. We would be pleased to provide further information or answer any questions you may have. Please feel free to contact me by email at pbourque@ific.ca or by phone at 416-309-2300.

Yours sincerely,

THE INVESTMENT FUNDS INSTITUTE OF CANADA

By: Paul C. Bourque, Q.C, ICD.D
President and CEO

APPENDIX A

IFIC RESPONSE TO SPECIFIC QUESTIONS OF THE CSA RELATING TO THE PROPOSED AMENDMENTS

Amendment of section 3.2 of NI 81-105

Proposed subsection 3.2(4) of NI 81-105 would prohibit fund organizations from paying trailing commissions where the participating dealer is not required to make a suitability determination in connection with a client's purchase and ongoing ownership of prospectus qualified mutual fund securities.

5. We expect that fund organizations will make available a trailing commission-free class or series of securities of a mutual fund to participating dealers who do not make suitability determinations. Would fund organizations have any issues with making available a class or series of securities of a mutual fund without trailing commissions to such participating dealers?

IFIC RESPONSE: If the OEO Proposal is adopted, our investment fund manufacturer members tell us it will not be difficult to make a trailing commission free class or series of securities of funds available for participating dealers who do not make a suitability determination. In some instances, revisions to prospectus disclosure will be necessary and could, subject to the specific facts, be completed at the next prospectus renewal. See also our response to Question 8.

6. Would fund organizations encounter any issues, including any operational challenges, in confirming whether a participating dealer has made a suitability determination, and is thus eligible to be paid a trailing commission in compliance with subsection 3.2(4) of NI 81-105? If so, please explain.

IFIC RESPONSE: It is not possible for investment fund managers to know with certainty whether an order from a participating dealer is in respect of a client for whom the participating dealer does not make a suitability determination. This would include an order for a permitted client who has waived the suitability obligation as well as an order from an order-execution-only (**OEO**) dealer. We understand that there are various practices in the industry for the use of dealer codes associated with an order. Some participating dealers use a separate code for an OEO dealer whereas other participating dealers use a single dealer code for multiple affiliated dealers. This results in aggregating mutual fund orders for full service dealers with orders for OEO dealers.

Moreover, an order for a permitted client who has waived the suitability obligation may come from a variety of sources and the investment fund manager cannot tell that the order is subject to the prohibition. The scenarios for permitted clients who have waived suitability may be further complicated where the client relationship is with a registrant such as a portfolio manager, who executes transactions through a participating dealer. In this case, we question whether the participating dealer will have sufficient information related to the purchase order to comply with the prohibition itself or to enable the investment fund manager to do so.

As a result, investment fund managers cannot determine if the prohibition applies when they receive a purchase order. Furthermore, as set out in our letter, under the existing regulatory framework, the investment fund manager is responsible for the offering of the mutual fund. The regulatory duty of the investment fund manager is to provide full, true and plain disclosure in the offering documents of the mutual fund. It does not have a regulatory obligation to determine which series is appropriate for an investor. Placing a prohibition on investment fund managers is contrary to the regulatory clarity that exists regarding the role of a reporting issuer, and would introduce an unnecessary regulatory burden on investment fund managers.

Transition Period

We anticipate that a transition period of 1 year from the date of publication of the final amendments is sufficient time for registrants to operationalize the Proposed Amendments.

7. Are there any transitional issues for fund organizations and participating dealers with implementing the Proposed Amendments within the proposed 1-year transition period? If so, please provide details of the relevant operational, technological, systems, compensation arrangements or other significant business changes required, and the minimum amount of time reasonably required to operationalize those changes and comply with the Proposed Amendments.

IFIC RESPONSE - DSC PROPOSAL: We expect fund managers would be able to adapt to a prohibition on the sale of funds using the DSC option within the contemplated transition period. However, many participating dealers will need more time to adapt their business model and make corresponding changes to their systems and compliance and training programs. Further, advisers will have to meet with clients to enter into new fee arrangements, which will be a lengthy process.

IFIC RESPONSE - OEO PROPOSAL: There are significant operational considerations relating to implementing the proposed ban, which cannot be addressed in a one-year period. Participating dealers will need to coordinate with investment fund managers to identify and make the appropriate series available on their product shelf and to switch clients to the appropriate series. Further, if participating dealers move to fee-based account arrangements, they will have to enter into new contractual arrangements with their clients.

Finally, participating dealers will need to address subsequent transfers-in of non-eligible series. We believe the final rule must address this by permitting the transfer-in, with a requirement to switch the client to the appropriate series within a reasonable period of time.

8. With the implementation of the Proposed Amendments, would the required changes to the disclosure in the simplified prospectus and fund facts documents within the proposed 1-year transition period necessitate amendments outside of a mutual fund's prospectus renewal period? Would these changes be considered to be material changes under NI 81-106?

IFIC RESPONSE: If the Proposed Amendments are adopted, we think their implementation could constitute a material change for the mutual fund depending upon the specific facts applicable to each fund organization. For example, if the final rule results in the capping of, or the ceasing to offer, a specific series, it may constitute a material change.

As a result, we believe that the final rule should provide a mechanism to manage the costs associated with a potential material change. We believe the mechanism could permit revised disclosure to be included in the next prospectus renewal with a future effective date indicated. Finally, disclosure of the DSC option would have to be included in fund offering documents until the final redemption schedule runs out to address disclosure for those investors who purchased under the DSC option and switch to another fund within the same fund family. The fund offering documents would have to indicate that the DSC option is not available for new purchases.

9. By the effective date of the Proposed Amendments, the CSA expect that those participating dealers who do not make suitability determinations in respect of a client will have switched any existing mutual fund holdings of such client to a trailing commission-free class or series of the relevant mutual fund.

(a) Switching a client from a class or series of securities of a mutual fund that pays a trailing commission to one that does not pay a trailing commission would trigger the delivery requirement for the fund facts document. As a transitional measure, should there be an exemption from the fund facts document delivery requirement for such switches? Such an exemption would mean that the investor would not have the right of withdrawal from the purchase, however, the investor would continue to have a right of action for rescission or for damages if there is a misrepresentation in the prospectus of the mutual fund, including any documents incorporated by reference into the prospectus, such as the fund facts document. In some jurisdictions, investors have a right of rescission with delivery of the trade confirmation for the purchase of mutual fund securities and this right would remain unchanged with such an exemption.

IFIC RESPONSE: We believe a permissive exemption, within the text of the rule itself, from both the fund facts document delivery requirement and the trade confirmation requirement can reduce the regulatory burden on, and costs incurred by, participating dealers. A permissive exemption will permit participating dealers, depending on their internal processes, to choose whether they will rely upon the exemption. We recommend the exemption be provided within the rule text in order to address switches on or prior to the effective date of the rule, and to provide for such switches for non-permissible mutual fund securities that are transferred to the participating dealer in the future.

(b) Are there any other types of exemptions from CSA or SRO rules that we should consider to facilitate switches to trailing commission-free classes or series of mutual funds? If so, please describe.

IFIC RESPONSE: As described in our response to Question 7, we believe the final rule must include transition provisions to effect the switch without client instruction. The final rule will also need to allow participating dealers to effect switches within a reasonable time period for transfers in of a series which pays a trailing commission. Further, as described in our response to Question 9(a), an exemption from the trade confirmation and fund facts document delivery requirements in respect of such transfers will also be required.

10. At this time, the CSA is allowing redemption schedules on existing DSC holdings as of the effective date of the Proposed Amendments to run their course until their scheduled expiry, and fund organizations to continue charging redemption fees on those existing holdings that are redeemed prior to the expiry of the applicable redemption schedule. Should the CSA propose amendments to require existing DSC holdings as of the effective date of the Proposed Amendments to be converted to the front-end load option or other sales charge option? If so, are there any transitional issues for fund organizations and participating dealers with converting existing DSC holdings to another sales charge option? What would be an appropriate transition period?

IFIC RESPONSE: If the DSC Proposal is adopted, we support permitting redemption schedules to run out. The economics of the compensation arrangement have already been agreed to and should not be changed by regulatory intervention. We would note that this is consistent with the approach taken by the UK Financial Conduct Authority as part of its Retail Distribution Review.

Regulatory arbitrage

11. We understand that the elimination of the DSC option may give rise to the risk of regulatory arbitrage to similar non-securities financial products, such as segregated funds, where such purchase option and its associated participating dealer compensation are still available. Please provide your thoughts on controls and processes that registrants may consider using, and on specific measures or initiatives that the relevant regulators should undertake, to mitigate this risk.

IFIC RESPONSE: If the DSC option for mutual funds is eliminated, there will be a risk of regulatory arbitrage to similar non-securities financial products such as segregated funds. Investors who prefer to pay through a DSC option may choose to invest in products such as segregated funds. Advisors may steer such clients with smaller amounts to invest in products where a DSC purchase option continues to be available to put the client's full investment amount to work right away. An advisor's goal is to seek a good investment outcome for their clients and, in some cases, the DSC option will achieve that.

We believe an unintended consequence of the DSC Proposal may result in smaller dealers whose business model relies on the DSC option ceasing to be registered under securities legislation while retaining the ability to sell insurance products to their clients. This will result in reduced investor choice, as these firms will only offer clients segregated funds rather than the most appropriate product.

The CSA alone cannot address the risk of regulatory arbitrage. Coordinated regulatory action is required.to create the right result for investors.

Modernization of NI 81-105

After the implementation of the Proposed Amendments, the CSA may consider future amendments to modernize NI 81-105, an instrument that has been in place since May 1998. The following questions will help inform the CSA's initiative to modernize NI 81-105.

12. Given that NI 81-105 aims to restrict compensation arrangements that can conflict with registrants' fundamental obligations to their investor clients, and given that the proposed Client Focused Reforms introduce the requirement for registrants to address conflicts of interests, including conflicts arising from third-party compensation, in the best interests of clients or avoid them, should the modernization of NI 81-105 entail a consolidation of its requirements into the registrant conduct obligations of NI 31-103?

13. NI 81-105 currently applies only to the distribution of prospectus qualified mutual funds. In our view, the conflicts arising from sales practices and compensation arrangements that are addressed by the provisions in NI 81-105 are not unique to the distribution of prospectus qualified mutual funds and also arise in the distribution of other investment products, either sold under a prospectus or a prospectus exemption. Are there other types of investment products that are not currently subject to NI 81-105, such as non-redeemable investment funds, certain labour-sponsored investment funds, structured notes and pooled funds that should also be subject to NI 81-105? If not, why should these investment products, their investment fund managers and the participating dealers that distribute them, remain outside the scope of NI 81-105?

14. We seek feedback on whether we should change the term "trailing commission" to a plain language term that investors would better understand and would better describe what a trailing commission is. If so, what are some suggested terms?

15. The definition of "participating dealer" in NI 81-102 carves out a principal distributor. As a result, principal distributors are not subject to the provisions of NI 81-105 that apply to participating dealers. Should the modernization of NI 81-105 contemplate the inclusion of principal distributors in the application of all the provisions of NI 81-105? Alternatively, are there specific provisions in NI 81-105 that should also apply to principal distributors? Please explain.

IFIC RESPONSE to Modernization of NI 81-105 Questions: We urge the CSA to finalize amendments to NI 31-103 and allow the industry to implement those amendments before considering whether further changes to NI 81-105 or consolidation of NI 81-105 and NI 31-103 are necessary. As noted in our submission on the Client Focused Reforms, we continue to view NI 81-105 as regulating all sales practices related to mutual funds, while the proposed amendments to NI 31-103 are intended to apply to other investment products. The proposed amendments to NI 31-103 are a good start towards creating parity in the treatment of third-party compensation for all investment products.

We are also of the view that there should not be any change to the term “trailing commission.” The term is used in a number of documents including Point of Sale documents and CRM2 reporting. Changing the term would result in unnecessary costs to revise the disclosure and reporting documents with no demonstrable benefit.