Federation of Mutual Fund Dealers
Fédération des courtiers en fonds mutuels

December 13th 2018 VIA E-MAIL ONLY

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
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
comments@osc.gov.on.ca

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
Consultation-en-cours@lautorite.qc.ca

Dear Sirs and Mesdames:

**RE: CSA Notice and Request for Comment on the Proposed Amendments to National Instrument 81-105 *Mutual Fund Sales Practices and Related Consequential Amendments***

The Federation of Mutual Fund Dealers (the "Federation") has been, since 1996, Canada's only dedicated voice of mutual fund dealers. We currently represent dealer firms with over $124 billion of assets under administration and 18 thousand licensed advisors that provide financial services to over 3.8 million Canadians and their families and as such we have a keen interest in all that impacts the dealer community, its advisors and their clients.

The Federation is pleased to provide comments on the captioned Proposals.

In April of 2013 the Federation provided comments to the CSA's consultation on 81-407 *Mutual Fund Fees.* In that paper you suggested *that there are other investment funds and comparable securities products whose fee structure may raise investor protection and fairness issues for investors.*

And in this current consultation you suggest that *the elimination of the DSC option may give rise to the risk of regulatory arbitrage.* We are disappointed therefore, that there doesn't seem to have been any attempts made to address this shortfall in those years. The industry has commented on regulatory arbitrage ad nauseum yet this 'unintended

consequence' has been given little more than lip service from regulators. The top-shelf choice will still be the path of least resistance.

You say that these proposed amendments appropriately respond to the issues you identified. With all due respect, this is what your motivation was for the initial CRM initiative, then CRM2. What were the results of your assessment of the impact of those initiatives? Tested and found lacking? Or not tested?

We find that the broad brush of 'investor protection' lacks any specific objectives against which each new proposed regulation can be measured in terms of its effectiveness in creating the change or obtaining the intended objective. With so many rules being proposed and imposed towards the broad objective of investor protection, and with the lack of time given to measure the impact of one regulation before another is imposed, we contend that the CSA will never be able to determine the impact or success of any new regulation. Further, how can rules be tweaked, or unintended consequences be corrected when we simply will not be able to point to the change or isolate the regulation that created problems in the first place?

**Definition of "member of the organization"**

1. Under the Proposed Amendments, we propose to expand the definition of "member of the organization" in NI 81-105 to capture an "associate", as defined under securities law, of the investment fund manager, of the principal distributor or the portfolio adviser of the mutual fund.

Aside from potential future modernization amendments contemplated further below, are there additional immediate changes or updates we should consider making to the definition in connection with the implementation of the Proposed Amendments? For example, would paragraph (e) of the definition still be relevant further to the elimination of the DSC option?

*"member of the organization" means, for a mutual fund*

*(a) the manager of the mutual fund,*
*(b) the principal distributor of the mutual fund,*
*(c) the portfolio adviser of the mutual fund,*
*(d) an affiliate of any of the persons or companies referred to in paragraph (a), (b) or (c), or*
*(e) a person or company that is organized by a member of the organization of the mutual fund as a vehicle to fund payment of commissions to participating dealers and that has a right to arrange for the distribution of the securities of the mutual fund;*

*"mutual fund family" means two or more mutual funds that have*
*(a) the same manager, or*
*(b) managers that are affiliates of each other; and "representative" means, for a participating dealer,*
*(a) a partner, director, officer or employee of the participating dealer,*

*(b) an individual who trades securities on behalf of the participating dealer, whether or not the individual is employed by the dealer, and*
*(c) any company through which a person referred to in paragraphs (a) or (b) carries on activities in connection with services provided to the participating dealer.*

Federation Comment: We have no objection to the expansion of the definition as noted in the proposals. Regarding paragraph (e) of the definition[1], as the determination has not yet been finalized to eliminate the DSC option, we would not recommend a change, and it may be relevant should a dealer choose to pay the fund company the gross proceeds of an investor's purchase and the fund company would deduct and send back to the dealer their sales commission as directed by the dealer.

**Repeal of section 3.1 of NI 81-105**

The proposed repeal of section 3.1 of NI 81-105 would prohibit fund organizations from paying any sales commissions to participating dealers. We expect the prohibition on fund organizations from paying upfront sales commissions to dealers for mutual fund sales made under the DSC option would effectively eliminate the DSC option, including its individual features, such as the redemption fee schedule and the related redemption fee.

2. Would the proposed repeal of section 3.1 of NI 81-105 have the expected effect of eliminating all forms of the DSC option? If not, what other measures should be taken to ensure that all forms of the DSC option are eliminated?

3. Would there be any sales practices and/or compensation arrangements with a redemption fee schedule and redemption fee that could exist despite the repeal of section 3.1 of NI 81-105?

If so, are rule changes required to specifically prohibit redemption fees that are charged for purposes other than to deter excessive or short-term trading in funds?

4. We do not expect that the repeal of section 3.1 of NI 81-105 will have any impact on the availability and use of other sales charge options, including the front-end load option as it currently exists today.

(a) Are there any unintended consequences on the front-end load option with the repeal of section 3.1 that we should consider?

(b) Are there any other types of sales charge options that will be impacted by repealing section 3.1?

[1] Paragraph (e) reads *a person or company that is organized by a member of the organization of the mutual fund as a vehicle to fund payment of commissions to participating dealers and that has a right to arrange for the distribution of the securities of the mutual fund*

Federation Comment: As the Federation has commented previously, we believe that investors should have and indeed have told us that they want as much choice as possible when they are investing and when they are paying for those services.

Most of the work performed by the distributors is at the front end of the transaction – risk profiling, portfolio asset allocation strategies, new client application form(s), know your client forms and questionnaires, client information gathering, account opening including the provision of and discussion of the myriad of disclosure forms which include fees paid, suitability research, supervision over the process, etc.

A review of the history i.e. 9% front end load charge in the 1980's (92% of funds invested) moving to deferred sales charge (5% front end commission plus trailing commission) to 0% front end load plus higher trailers has pushed the compensation out over a significant length of time regardless of the fact that this time and service is largely provided at the front end, but, as we have stated above, is ongoing.

In addition, the DSC option motivated clients to adhere to a buy-and-hold strategy, a sound strategy for many investors and one that has in fact, buoyed bear markets in the past. It is important to note here that clients may switch or withdraw 10% annually (withdrawal could meet RIF withdrawal requirements), they may switch out of a fund entirely and invest in another fund within the same fund family without being charged fees, and, that many mutual fund dealers have made it a policy to reimburse clients any DSC fees that they may attract when transferring out of one fund family and into a new fund family.

We would, therefore, recommend that the CSA continue to allow the use of DSC funds where it is deemed suitable for the client.

**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 dealers?

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.

Federation Comment: F-class funds already exist, and we are not sure that the creation of additional funds are required; if they are however, they could be introduced for those dealers and their advisors who do not make a suitability determination.

The Federation does not represent fund companies, but we are not sure how they would be able to determine whether advice was attached to an order.

**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.

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?

9. By the effective date of the Proposed Amendments, the CSA expect that those 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.

(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.

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?

Federation Comment: We agree that there should be an exemption from the fund facts document delivery requirement for the switches described in 9(a) above.

A one-year transition time will be too short for dealers and their advisors, and this is about more than just eliminating DSC. Dealers and advisors will have to reengineer their business models. It will be a complex process for most if not all. The contracts between the advisors and their dealers will have to be renegotiated. Back office and accounting changes will have to be made. Technology costs will increase as dealers and manufacturers transition their systems from built-in commissions and trailers to accommodate an up-front fee-for-service model. Compliance costs will increase exponentially as compliance staff at the dealer change their disclosure requirements, monitoring and supervisory regimes in order to consider how advisors are representing the services they provide against fees.

This will be a significant cultural shift for everyone involved, but most important in the equation is the client, and the advisor will have to be trained to have conversations not just about their value proposition, but about the client writing a cheque to the advisor.

The Federation conducted an independent qualitative research study in preparation for our submission on the CSA Consultation Paper 81-408 – *Consultation on the Option of discontinuing Embedded Commissions*. Our research showed, amongst other things, that:

- Investors value payment convenience (77% of participants want the option to continue to pay indirectly), and
- With a direct pay approach, investors may forego paying for advice and choose investing alternatives that may not support good long-term investing behavior.

We would recommend a three-year transition period from the date of publication of the final amendments, that that should a ban on the DSC option become final, existing DSC schedules should be allowed to run their course.

**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 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.

Federation Comment: As we have said in the past, it is essential that the impact of proposed policies across all channels of distribution be assessed to ensure that the imposition of the policy does not disadvantage one channel over another.

**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 nonredeemable 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 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.

Federation Comment: We don't believe that changing the name of the 'trailing commission' will change anything. If it is described correctly it is in fact an apt description; it trails after the advisor after the sale.

We recommend that the CSA finalize their amendments to NI 31-103 and allow this NI 81-105 consultation to run its course before entertaining any ideas of consolidation of or further change to, the National Instruments. The industry will require time and resources to implement the final Instrument(s) and the CSA will require time to assess the efficacy of the changes prior to undertaking another consultation of these Instruments.

The Federation appreciates the opportunity to comment on the Proposals. We would be pleased to provide further information, and/or participate in any additional general or targeted consultations or answer any questions you may have. Please feel free to contact me by email at sandra@kegieconsulting.com or by phone 416-621-8857.

Regards,

Federation of Mutual Fund Dealers

Sandra L. Kegie
Executive Director