FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

October 17, 2009

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Re: Proposed Amendments to National Instrument 81-101 *Mutual Fund Prospectus Disclosure*, Forms 81-101F1 and 81-101F2 and Companion Policy 81-101CP *Mutual Fund Prospectus Disclosure*, and related amendments

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We are pleased to provide you with the comments of the Canadian Foundation for Advancement of Investor Rights (**FAIR Canada**), in response to the request for comment with respect to the proposed amendments relating to the sale of mutual funds to retail investors.

FAIR Canada is a non-profit, independent national organization founded in 2008 to represent the interests of Canadian investors in securities regulation. Additional information about FAIR Canada, its governance, and priorities is available on our website at www.faircanada.ca.

General

Support for CSA Goal - As we noted in our comment letter dated January 23, 2009, we strongly support the goal of the Canadian Securities Administrators (the **CSA**) to provide investors with clear, meaningful and simplified information when the investor needs it most: before or at the time they make their decision to invest their savings in a mutual fund or segregated fund.

This submission describes our views with respect to the point of sale disclosure initiative as it relates to the sale of mutual funds. Where applicable, we have cross-referenced the CSA's specific 'Issues for

Comment' noted in Appendix B to the *CSA Notice and Request for Comment – Implementation of Point of Sale Disclosure for Mutual Funds*, dated June 19, 2009.

1. Cooling off/Cancellation right

We remain firmly of the view that the proposed "cooling off" right diminishes investor rights when compared to existing withdrawal and rescission rights. The asymmetry (investor exposed to loss but not profit) is both unfair and unnecessary.

(1) **"Withdrawal Right" Already Exists** – Investors currently have a statutory right of withdrawal within 2 days of the date of delivery of the prospectus, as well as a right of rescission for mutual fund purchases of $50,000 and less. The "withdrawal right" is a true "cooling off" right (as that term is used in consumer legislation) that already exists in law in most provinces. The CSA is proposing to take away these existing rights of retail investor and substitute lesser rights.

(2) **Not a True "Cooling-off" Right** – We note that the CSA is now referring to the substitute for existing rights as a "cancellation right", whereas up until the June 2009 proposal, it was called a "cooling off". Calling the provision a "cooling off" right or a "cancellation" right is both misleading and a misnomer. Cancellation rights in consumer protection legislation generally allow a consumer to cancel a contract within a specific period of time at no cost to the consumer – the consumer is put back into his/her pre-contract position. For example, under the *Condominium Act* (Ontario)[1], a developer must refund, without penalty or charge, all money received from a purchaser under an agreement of sale, together with interest on the money calculated at a prescribed rate, if a notice of rescission is received within 10 days of the agreement. Under the *Consumer Protection Act* (Ontario), a consumer may, without any reason, cancel a direct agreement within 10 days of receiving the written copy of the agreement.[2]

The right proposed in the current point of sale initiative is more akin to a cancellation (where mutual fund increases in value) and a redemption right (where the mutual fund declines in value).

(3) **No Problem Exists** – We have spoken with IFIC and some leading mutual fund companies and have been advised that (i) they have not lobbied to change the existing withdrawal rights and (ii) the existing withdrawal rights have not been abused. Therefore, it appears that the CSA is reducing investor rights to address a problem that does not exist. If the objective is

[1] *Condominium Act, 1998, S.O. 1998, c.19* at subsection 73(3).
See http://www.e-laws.gov.on.ca/html/statutes/english/elaws_statutes_98c19_e.htm.
[2] *Consumer Protection Act*, 2002, S.O. 2002, c. 30 at section 43.

harmonization, why would the CSA not harmonize based on a true "cooling off" right where the investor can simply cancel within 2 days and receive the return of his or her funds?

(4) **Investor Protection Mandate** – The provincial securities commissions, including the Ontario Securities Commission, have investor protection as a primary statutory mandate. This proposal to reduce investor rights is inconsistent with this mandate.

(5) **If Retail Investors Lose, Who Benefits?** – Under the proposed and misnamed "cooling-off" or "cancellation" right, retail investors will not benefit if the NAV of the mutual fund increases in value. They will simply receive the return of their initial investment. Who benefits from the increase in value that is not going to the retail investor? Will the profit go to the mutual fund or will it go to the salesperson who sold the product to the client? This point is not addressed in the CSA proposal. From our review of the proposed amendments to NI 81-101, clarification is needed about who gets the profit.

(6) **International Initiatives to Increase Investor Protection** - While investor rights are being enhanced in leading jurisdictions around the world like the US, UK, Australia and Hong Kong, in Canada, we appear to be moving backwards. Investors and investor advocates may wish to ask their member of the provincial legislature why the provincial commissions are reducing investor rights.

(7) **Asymmetry** - In the CSA Notice, the CSA talks about addressing the "information asymmetry" that exists between participants in the mutual fund industry and investors. With its proposed depreciated cancellation right, the CSA introduces a new "asymmetry" – investors are exposed to market fluctuations and they can lose but they can't win.

In conclusion, the effect of the cancellation right proposed in National Instrument 81-101 is that, in exercising the right in a case where the value of the mutual fund investment has fallen, a consumer is left with less than his or her original investment. However, in the reverse situation of an increase in the value of the investment, the consumer is not permitted to share in the upside. No one knows who gets the benefit from the "upside". This proposal is at odds with the goal of improving investor protection and with the general approach of consumer protection legislation. We see no reason why current legislation is being amended so that, in the event that investors exercise their cooling off right, they are exposed to the downside risk but cannot share in the upside.

Recommendation: FAIR Canada recommends that the CSA retain the existing withdrawal rights where investors can cancel the contract and receive the return of their investment. In the alternative, it is only fair that the CSA mandate that, with the new cooling off/cancellation right, investors obtain the benefit of the upside if they are exposed to downside risk.

2. Retail Investors Will No Longer Receive the Simplified Prospectus

We remain firmly of the view that the mutual fund's simplified prospectus should be provided to investors either at the point of sale or with the trade confirmation. While the Fund Facts (FF) document provides useful information in a brief, two-page (3 sides) simplified format, the simplified prospectus provides vital information to investors, particularly retail investors.

(1) **Simplified Prospectus Contains Material Information** - As noted in *Securities Law in Canada: Cases and Commentary*[3]:

> It is also important to bear in mind that prospectuses are less important for major investors, because they frequently have the information and resources to undertake their own due diligence in the investigation of an offering. ***For the less sophisticated investor, the prospectus provides the primary, if not sole, source of accurate information on the offering, and hence, the gate keeping role of the regulatory authorities in respect of the prospectus process is considered vitally important.*** [emphasis added]

The mutual fund's simplified prospectus is required to contain numerous details that are of vital importance to the investor, and to the investment decision.

(2) **Fundamental Principles of Securities Regulation** – Since the origins of securities regulation, persons selling securities to investors have been required to deliver a prospectus which contains "full true and plain disclosure of all material facts". As one academic notes: "The requirement to prepare a prospectus pursuant to a distribution of securities [is] ***considered to be the paradigmatic substantive requirement of Canadian securities law***".[4] [emphasis added]

The CSA proposal to reverse the onus and to require that an investor expressly request a prospectus before getting one is a major policy change. Setting <u>non-delivery</u> of a simplified prospectus as the <u>default</u> position means that the prospectus will not be delivered to the great majority of retail investors. The least sophisticated retail investors are the ones least likely to receive the prospectus. This is a major change, and is inconsistent with the position of securities commissions for decades.

(3) **Mandate a Plain English Simplified Prospectus** - In response to our January 2009 submission, the CSA agrees that the simplified prospectus contains useful information but notes that "investors have trouble finding and understanding the information because it is a long and complex document." **It is our submission that the length and complexity of the simplified prospectus represents a regulatory failure to mandate**

[3] Condon, Anand and Sarra. *Securities law in Canada: Cases and Commentary* (Toronto: Emond Montgomery, 2005) at 294.
[4] Yalden, R. *Business Organizations: Principles, Policies and Practice* (Toronto: Emond Montgomery, 2008) at 413.

and enforce the production of a document that is simpler and written in plain English rather than legalese. The appropriate regulatory response to this problem is to require a simpler, plain English simplified prospectus. Instead, the CSA effectively neglects its responsibility to require the production of simpler documents. It decides that the simplified prospectus will remain a "long and complex document" and it will not be given to investors except those who expressly request it and, in any event, few if any investors will understand it.

With respect, the position of the CSA on delivery of a simplified prospectus represents an abdication of regulatory responsibility.

We remain firmly of the view that the mutual fund's simplified prospectus should be provided to investors either at the point of sale or with the trade confirmation.

Recommendation:

(1) The simplified prospectus should continue to be delivered to all investors – delivery with the trade confirmation would be sufficient; and

(2) The CSA makes it a priority to reduce the length and complexity of the simplified prospectus and mandate that it be written in plain English.

3. Contents of Funds Facts (FF)

(a) Fees and expenses – Disclosure of TER – Issue III.8

We recognize that there is currently a requirement under Part 3 of NI 81-106 that the Trading Expense Ratio **(TER)** be disclosed in a mutual fund's annual and interim Management Report of Fund Performance.

We note that a TER can constitute a significant expense for a mutual fund: In 2007, while the average TER for the 25 largest equity, balanced and monthly income funds by assets was only 0.06 per cent, aggressive equity funds had TERs ranging from 0.5 to 3 per cent[5]. Consequently, FAIR Canada recommends that the CSA further analyze the point at which disclosure of the TER of a fund would be material to an investor, and add guidance to the Companion Policy stating, for example, that "the TER of a fund should be disclosed in the FF if it is greater than x%" (with "x" being the percentage that the CSA concludes, after analysis, is the appropriate threshold).

Recommendation: We recommend that the CSA further analyze the point at which disclosure of the TER of a fund would be material to an investor, and add relevant guidance to the Companion Policy regarding the inclusion of disclosure of the TER, where appropriate, in the FF document.

[5] See https://secure.globeadvisor.com/servlet/ArticleNews/story/gam/20070414/STMAIN14.

(b) Fees and Expenses – Presentation – Issue III.7

FAIR Canada recommends that data with respect to fees and expenses be presented in both percentage format and 'dollars and cents'. Fees and expenses are a vital consideration for investors when selecting a mutual fund. Being armed with information about fees and expenses in both percentage format and absolute numbers enables investors to gain a clearer understanding of the impact of those fees and expenses on potential returns. Studies have shown that Canadian investors pay among the highest mutual fund management fees, and this can have a significant long-term impact on investor returns.

Recommendation: As information on fees and expenses is critically important for investors to understand, we recommend that data with respect to fees and expenses be presented in both percentage format and 'dollars and cents'.

(c) Performance Reporting

We believe that the current proposal presents an opportunity for Canada to be at the forefront of investor protection. We recommend that the CSA require performance comparisons to appropriate index benchmarks. Investors need to be equipped with as much useful information as possible when making their investment decision. We recommend that the CSA review this issue with a view to formulating a proposal for public comment to require performance comparisons to appropriate index benchmarks by June 2010.

Recommendation: FAIR Canada recommends that by June 2010 the CSA formulate a proposal for public comment to require performance comparisons to appropriate index benchmarks.

(d) Disclosure of After-Tax Returns

We recommend that the CSA require disclosure of after-tax returns in the FF. We also recommend that funds be required to disclose the percentage, on an after-inflation basis, that is consumed by various fees and charges (we note that this disclosure could be provided on a before-tax basis). This will improve the quality of disclosure and help investors understand the impact of taxes and inflation on their investments. We note that, in the United States, the SEC requires disclosure of after-tax returns[6]. In its *Final Rule: Disclosure of Mutual Fund After-Tax Returns*[7], the SEC notes:

> Despite the tax dollars at stake, many investors lack a clear understanding of the impact of taxes on their mutual fund investments…**Taxes are one of the largest costs associated with a mutual**

[6] Page 3 of the SEC's hypothetical Summary Prospectus includes a chart disclosing 1, 5, and 10 year returns both before and after taxes. Taxes are calculated using the highest individual federal marginal income tax rate and do not take into account state and local taxes. See http://www.sec.gov/comments/s7-28-07/s72807-142-hyp.pdf. See also *Final Rule: Disclosure of Mutual Fund After-tax Returns* at http://www.sec.gov/rules/final/33-7941.htm.
[7] 17 CFR Parts 230, 239, 270, and 274.

> **fund investment, having a dramatic impact on the return an investor realizes from a fund.** Disclosure of standardized mutual fund after-tax returns will help investors to understand the magnitude of tax costs and compare the impact of taxes on the performance of different funds. [emphasis added]

It is clear that investors need standardized disclosure of mutual fund returns, taking into account taxes and inflation, in order to make informed investment decisions.

Recommendation: FAIR Canada recommends that the CSA require disclosure of after-tax and inflation-adjusted returns in the FF.

(e) Risk disclosure

As noted below under "Comments on SIPA letter", we agree with SIPA that mutual funds should be required to disclose in the risk disclosure section of the FF the worst 12-month return for the fund. The information would equip investors with a greater understanding of the risks they might need to bear if a similar twelve-month return period were to recur. Although past performance is not an accurate indicator of future returns, investors frequently do not fully understand the risks associated with mutual fund investments. Clearly showing investors a 'worst-case scenario' can drive home the message that investing in a mutual fund can be risky, with the potential to result in a loss of the investment.

FAIR Canada does not believe that the IFIC Fund Risk Classification Model would accurately capture the various forms of risk to which investors may be subject. We also agree with SIPA that the CSA should require mutual funds with significant exposure to currency fluctuations to state their hedging policy.

Recommendation: We recommend that mutual funds be required to disclose in the risk disclosure section of the FF the worst 12-month return for the fund. We also recommend that the CSA require mutual funds with significant exposure to currency fluctuations to state their hedging policy.

(f) Cautionary language

We recommend that the current cautionary language in the FF document ("the FF may not have all the information you need") be strengthened. For example, the term 'may' should be replaced with 'does', so that the sentence reads as follows: "the FF does not have all the information you need…" We suggest moving the cautionary language to the top of page 1 of the FF document.

Recommendation: We recommend that the cautionary language be strengthened and moved to the beginning of the FF document. The language should make it clear that the FF document <u>does not</u> have all the information that is material to an investment decision.

4. Delivery of FF

(a) Distinction between 'dealer recommended' and 'non-recommended' trades

FAIR Canada is of the view that the distinction described in section 7.5 of Companion Policy 81-101CP between 'dealer recommended' and 'non-recommended', or between 'investor-initiated' and 'adviser-recommended' trades is not the appropriate test for non-delivery of a FF document and does not take into account the varying degrees of sophistication and knowledge that individual investors have. We recommend that the CSA consider dividing clients into categories based on their knowledge, experience and sophistication rather than whether the client or salesperson made the phone call/returned the phone call etc. Treatment based on sophistication of the investor is a more conceptually sound basis for differentiation.

One example we reviewed was the *Corporations Act* in Australia (the Australian Act), which distinguishes between 'retail clients' and 'wholesale clients'. Under relevant provisions of the Australian Act, retail clients must receive greater levels of disclosure than wholesale clients. While the Australian Act lists a number of possible criteria for being a wholesale client, of particular relevance is the following:

> *"[a person] that a financial services licensee… is satisfied has previous experience in using financial services and investing in financial products that allows [the person] to assess the merits, value and risks of the investment [amongst other things], … the licensee gives [the person] a statement of its reasons for being satisfied as to those matters… and the person signs a written acknowledgement"*[8].

FAIR Canada is of the view that a distinction between retail and wholesale or sophisticated clients premised on the degree of previous investing experience, as above, would better serve the goal of investor protection than the proposed investor-initiated/adviser-recommended distinction.

Recommendation: FAIR Canada recommends that the distinction between dealer-recommended and non-recommended trades be changed to a distinction premised on the degree of previous investing experience.

(b) Delivery of FF for each fund class/series

FAIR Canada is of the view that a mutual fund should be able to include multiple series or classes in a single FF document but, in such circumstances, the CSA should require the inclusion of comparative information (particularly with respect to fees) between the different series or classes of funds. This would ensure that a balance is struck between reducing potential costs for funds in preparing additional FF documents, and ensuring that useful comparative information is provided to investors.

[8] *Corporations Act 2001* – S.761G and S.761GA.

Recommendation: We recommend that a mutual fund be able to include multiple series or classes in a single FF document, provided that comparative information is included.

(c) Waiver of FF delivery

We do not believe that investors should be able to waive delivery of the FF. The FF is an essential source of important information for investors, and therefore investors should not be permitted to waive delivery.

Recommendation: FAIR Canada recommends that investors not be permitted to waive delivery of the FF.

(d) Electronic delivery

Recommendation: We recommend that the CSA clarify, in Companion Policy 81-101CP, that the electronic delivery requirement is satisfied either by:

(a) sending an electronic copy of the FF, or
(b) sending an email with a direct link to the FF.

5. Applicability of Regime to Similar Investment Products

FAIR Canada is encouraged by the response to comments by the CSA dated June 19, 2009, in which the CSA notes that, "we expect disclosure for all types of investment funds will evolve with time, and **we anticipate that point of sale disclosure for mutual funds and segregated funds may provide a platform for future regulatory reform**" [emphasis added]. We consider the point of sale initiative to be an important first step in ensuring that investors are provided with the information they need to make a mutual fund investment decision. The initiative is consistent with similar proposals in the European Union and the U.S. We agree with the CSA that the initiative can provide a platform for future regulatory reform for other types of investment products.

Recommendation: FAIR Canada recommends that the CSA consider how the point of sale disclosure for mutual funds and segregated funds can provide a platform for future regulatory reform for other types of investment funds with a view to publishing a proposal for public comment by June 30, 2010

6. Comments on SIPA letter

In preparing our comment letter, we reviewed the letter submitted by the Small Investor Protection Association (**SIPA**), dated August 26, 2009. The SIPA submission was well researched and written and we recommend that the CSA give serious consideration to its recommendations. We agree with the SIPA submission on many points, including:

(a) the current notice and public comment procedures are not adequate for meaningful public consultation – we would be happy to participate in a face-to-face forum with the CSA to discuss the proposed changes,

(b) the FF document does not need to be delivered to an investor on the subsequent trade of a mutual fund of the same series/class (Issue #II(3)),

(c) additional cautionary language, such as that required in the US Summary Prospectus, should also be required in the FF document,

(d) the description of a fund's investment objectives should be limited to information that is both meaningful and material,

(e) mutual funds with significant exposure to currency fluctuations should be required to state their hedging policy,

(f) a Companion Guide should be prepared by the regulators to explain the FF document and key terms,

(g) guidance should be provided in Companion Policy 81-101CP regarding what would constitute a material change to the information contained in the FF,

(h) illustration in the FF of the amounts payable by an investor, with respect to sales charges and ongoing fund expenses, in dollars and cents,

(i) risk disclosure should precede the discussion of past performance and should include a description of the worst 12-month return for the fund, and

(j) the description of fees and expenses should be placed at page 1 of the FF document, ahead of performance data.

We also note SIPA's support of FAIR Canada's recommendations with respect to the cooling off/cancellation right and delivery of the simplified prospectus.

One area where FAIR Canada does not agree with SIPA is the suggestion for an acknowledgement requirement for the FF. While the objective is worthy, we are concerned that it may not achieve enough to warrant another road block to implementation of the initiative in the near future. If delivery of the FF document satisfies the prospectus delivery requirement, and the statutory prospectus has no acknowledgement requirement, then we believe that an acknowledgment is also unnecessary for the FF.

The requirement for delivery of the FF document prior to or at the point of sale is sufficient to ensure that investors receive the information contained in the FF prior to making an investment decision. It is also our understanding that if there is a failure to deliver a FF document, this may give the investor an open-ended right of rescission since the "cooling-off" period is proposed to run from the time of delivery of the FF document.

7. Transition

We support the CSA's proposal to move forward sooner with certain requirements (such as the requirement to prepare and file a fund facts document and have it posted to the website), and to continue to consult on other parts of the instrument. We believe that it is crucial for the CSA to move forward as quickly as possible on this instrument, since it has taken since 1999 to arrive at this stage.

We believe that this is an important initiative where, although we have serious concerns about certain aspects of the proposed amendments (as we have noted in this letter), we nonetheless call upon the CSA to move forward as expeditiously as possible with this project so that investors can benefit from disclosure that is clear, streamlined, and user-friendly. We do not believe that a two-year transition period (which would delay implementation until 2012) is necessary for industry: We believe that a six-month transition period would be sufficient, particularly given the length of time that this project has been ongoing. As described in the CSA Notice and Request for Comment dated June 19, 2009, key dates for this initiative include:

1999: Publication by the Joint Forum of Financial Market Regulators of *Comparative Study of Individual Variable Insurance Contracts (Segregated Funds) and Mutual Funds* and *Recommendations for Changes in the Regulation of Mutual Funds and Individual Variable Insurance Contracts*

February 13, 2003 - *Consultation Paper 81-403 Rethinking Point of Sale for Segregated Funds and Mutual Funds,* published by the Canadian Securities Administrators and Canadian Council of Insurance Regulators, as members of the Joint Forum.

June 15, 2007 - *Proposed framework 81-406 Point of sale disclosure for mutual funds and segregated funds*, published by the Joint Forum.

October 24, 2008 - Framework 81-406 *Point of sale disclosure for mutual funds and segregated funds,* published by the Joint Forum.

June 19, 2009 – Publication of *CSA Notice and Request for Comment – Implementation of Point of Sale Disclosure for Mutual Funds*- Proposed Amendments to NI 81-101 Mutual Fund Prospectus Disclosure, Forms 81-101F1 and 81-101F2 and Companion Policy 81-101CP Mutual Fund Prospectus Disclosure Given that the pace of progress on this initiative has been very slow, we urge the CSA to reduce the transition period so that we are not three years away from implementation.

Recommendation: FAIR Canada recommends that the transition period from the effective date of NI 81-101 be moved from two years to six months. We believe that a six-month transition period is more than adequate, given the many years that the project has been ongoing.

Conclusion

We call on the CSA to retain existing investor rights with a proper "cooling off" period and a default position of delivery of the Simplified Prospectus to the investors. These do not involve a change from the current position.

We expect that any material change to the proposed amendments to the FF document would result in further delays in implementation of the point of sale initiative for mutual funds. We support proceeding with the proposed amendments in order to avoid further delay. However, the FF document should be carefully reviewed by the CSA upon implementation of the initiative, with a view to ensuring that the disclosure provided to investors in the FF document is further improved and clarified.

We would be pleased to discuss our comments with you in more detail at any time.

Sincerely,

Canadian Foundation for Advancement of Investor Rights (FAIR Canada)