September 23, 2011

The Hon. James Flaherty
Department of Finance Canada
140 O'Connor Street
Ottawa, Ontario K1A 0G5

Sent by mail and Email: jflaherty@fin.gc.ca

An Open Letter to The Federal Minister of Finance

Dear Minister Flaherty:

Re: Price Differences between Canadian and U.S. Mutual Funds

FAIR Canada supports your recent announcement that the Canadian Government wants to examine why prices in Canada are much higher than in the U.S. You have asked the Senate National Finance Committee to examine the price differential between Canadian and U.S. products. Many retail products, such as clothing, sporting goods, electronics and other items are significantly more costly in Canada than they are in the United States, despite the fact that Canada's dollar has been at par or higher in value versus the US dollar for some time.

FAIR Canada urges you to include an examination of the high cost of owning mutual funds for Canadians compared to Americans. Canadians have a significant amount of their wealth invested in mutual funds and similar financial products, with approximately $620 billion invested in mutual funds alone. Many studies have shown that Canadian funds have significantly higher costs than their US counterparts. For example, in March 2011 Morningstar released its Global Fund Investor Experience 2011 report (the "Morningstar Report") which found that "Canada fails for Fees and Expenses" and awarded Canada a failing grade (an F-) in the category of fees and expenses. The Morningstar Report found that "Canada is the only country in the survey with TERs [total expense ratios] in the highest grouping for each of the three broad categories." Canadians should not have to continue to pay the highest mutual fund fees compared to other countries.

According to the Morningstar Report: the median asset weighted expense ratio of fixed-income funds in Canada is 1.31% compared to 0.75% for the United States; the median asset-weighted expense ratio of equity funds in Canada is 2.31% compared to 0.94% in the United States; and for money market funds it is 0.80% in Canada compared to 0.47% in the United States.

If you compare a domestic equity fund offered by the same fund company in both countries you will find that costs are higher in Canada. We chose Fidelity Investments randomly. A domestic large cap fund offered by Fidelity Investments in the United States has a TER of 0.94% whereas a similar domestic large cap fund offered in Canada by Fidelity had a TER of 2.84%[1].

As part of the examination, the Senate National Finance Committee should ask why the Canadian market bears such high costs as compared to the U.S. The mutual fund industry argues that there are higher fees in Canada versus the US, in part, because of the greater economies of scale that are possible in the US market. Studies have shown that countries that have a smaller fund industry than Canada still have lower fees.[2] The Morningstar Report states that while the claim that the United States has lower fees and expenses due to greater economies of scale has some merit, it cannot explain why Canadian fund expenses are significantly higher than those in other countries with smaller populations.[3]

It appears that the fees that are charged are based on what the market can bear.[4] The fund industry provides incentives such as trailing commissions to salespersons in order to incent them to sell their product to investors over others. Fund companies compete based on who provides the highest trailing commission to the salesperson rather than on the cost of the fund to the investor or the best product for the investor. This is similar to the situation with respect to pharmacies in Ontario where rebates were paid by drug manufacturers to pharmacists to incent them to sell their generic drugs. Legislation has now been passed in Ontario to address the issue with respect to generic drugs.

FAIR Canada believes that part of the blame for excessively high fees rests with the Canadian regulatory system. Canadian financial firms charge high fees to consumers simply because they are able to do so under the current regulatory environment where there is limited price competition. While provincial securities regulators have done a good job of fostering competition in other areas of the financial markets, they have not done enough to encourage price competition among mutual funds and other financial products sold to retail investors. The regulatory system does not provide true transparency in fees with “trailing commissions” being paid by product manufacturers to financial firms out of fees charged to consumers. Most consumers are not aware of the payment of “trailing commissions”.

Although financial firm marketing implies that firms and advisors act in the client’s best interest, there is no actual legal obligation that advisors provide advice that is in the best interest of the client. The absence of a duty to act in the client’s best interest (or a fiduciary duty) allows the advisor to take advantage of the ignorance of the client, maximizing the financial compensation to the advisor at the expense of the client. Many investors are sold what their advisor recommends, which will very often be a mutual fund or other financial product with excessively high fees. The recommendation does not have to consider other products that may have lower costs. FAIR Canada is hopeful that the National Securities Regulator that you have championed, and that FAIR Canada strongly supports, will be able to address these issues.

The high cost of owning mutual funds impacts the ability of Canadians to adequately accumulate savings for their retirement. Better investor protection in securities regulation, including increased price

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1 See Fund Facts for Fidelity Canadian Large Cap Fund Series B versus the SEC’s Summary Prospectus for the Fidelity Blue Chip Growth Fund Summary Prospectus.

2 See the Financial Times article Funds, fees, fairness and economies of scale” on September 2, 2011 at http://www.ft.com/cms/s/0/444a272c-d54d-11e0-bd7e-00144feab49a.html which finds that fees charged are not based on the costs of the funds but what the market will bear.

3 See page 58 of the Morningstar Report.

4 See the Financial Times article, above at footnote 2.

competition in Canada, would be of benefit to millions of Canadians and would be supportive of the government's objective to improve the retirement savings adequacy of Canadians.

FAIR Canada believes the Canadian mutual fund industry's high fees and expenses is an issue of real importance to Canadians and should be examined by the Senate National Finance Committee.

We would be happy to discuss this matter further with you.

Sincerely,

Ermanno Pascutto

Executive Director, FAIR Canada

Cc: FAIR Canada Board of Directors:
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