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

May 26, 2014

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumers Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Financial and Consumer Services Commission (New Brunswick)
Office of the Superintendent of Securities, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Office of the Superintendent of Securities, Nunavut

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RE: CSA Notice and Request for Comment – Implementation of Stage 3 of Point of Sale Disclosure for Mutual Funds – Point of Sale Delivery of Fund Facts

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FAIR Canada is pleased to offer comments on the Canadian Securities Regulators ("**CSA**") Notice and Request for Comment regarding Implementation of Stage 3 of Point of Sale Disclosure for Mutual Funds dated March 26, 2014 (the "**Notice**"), which will require the pre-sale delivery of the fund facts document for mutual funds ("**Fund Facts**").

FAIR Canada is a national, non-profit, charitable organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

EXECUTIVE SUMMARY

1. FAIR Canada supports the requirement for pre-sale delivery of Fund Facts to all retail investors in order to assist investors in their decision-making process **prior to** making an investment decision.
2. Exceptions to pre-sale delivery should be rare given the nature of mutual fund investments and existing technology. FAIR Canada recommends that securities regulators closely review the use of the "investor cannot wait for delivery" exemption to ensure that it is not the result of high pressure sales tactics and is only used in appropriate circumstances. FAIR Canada stresses the need for effective compliance and enforcement regimes to ensure that Fund Facts are delivered to retail investors prior to the point of sale.
3. We also encourage investor testing of the Fund Facts document after implementation of the pre-sale delivery requirements in order to ensure that the Fund Facts document is meeting its disclosure objectives and that it is understood and used by investors as anticipated and expected. We recommend that any necessary changes be made in light of the findings.
4. FAIR Canada supports efforts to implement a point of sale regime for other investment products such as ETFs and urges securities regulators to proceed with such initiatives.
5. FAIR Canada believes that disclosure is important and that the point of sale initiative is a worthwhile endeavour. However, disclosure is not a panacea for the existing gaps in financial consumer protection. We caution regulators against relying solely on disclosure and encourage continued progress on initiatives aimed at bolstering protection for retail financial consumers such as implementing a statutory best interest standard and banning embedded trailing commissions. FAIR Canada recommends that members of the CSA consider the findings made in the area of behavioural economics, both in terms of designing Fund Facts for mutual funds and other investment funds such as ETFs (i.e. improving disclosure) and also in considering how to ensure adequate investor protection.
6. FAIR Canada recommends that the "Understanding mutual funds" brochure be reworked and updated as set out in section 7. This document was originally developed before the point of sale project for Fund Facts began and is not a useful guide to understanding Fund Facts or furthering understanding of mutual funds and their different fee models, compensation structures, conflicts of interest and other important features.
7. FAIR Canada believes that a transition of one-year following the effective date of the proposed amendments should not be further extended while other issues are determined, such as the risk classification methodology.

1. Require Pre-Sale Delivery to All Retail Investors

1.1. FAIR Canada supports the requirement for pre-sale delivery of Fund Facts to all retail investors whether they use the services of a representative or a discount broker. The intended purpose of the Funds Facts document is to provide a plain language document to assist investors in their decision-making process **prior to** purchasing a mutual fund. Therefore, securities regulators must mandate that this occur.

1.2. It is seemingly obvious that, in order to improve an investor's decision-making, the Fund Facts document needs to be provided before the sale. As stated by the Joint Forum of Financial Market Regulators: "[t]he information must be given to investors when they are making their decision to buy a fund – in other words, before the investor gives instructions to buy the fund."[1] As the CSA is well aware, "[i]nvestors want to receive the Fund Facts sheet prior to the sale or have their financial adviser go over it with them. **It would not be useful to receive it after the sale.**"[2] [emphasis added]

1.3. Furthermore, investors' behavioural biases also "...decrease the likelihood that they will... exercise their right to cancel their purchase even after receiving information that tells them their original purchase decision was unwise."[3] Therefore, FAIR Canada fully supports Stage 3 of the Point of Sale initiative, namely pre-sale delivery.

2. Exceptions to Pre-Sale Delivery Must be Rare

2.1. Any exceptions to the requirement for pre-sale delivery should be rare so that the exception does not end up becoming the norm. Given existing technology and the fact that most mutual funds are sold on the basis that they are intended to be long-term investments, we do not foresee many instances where an investor would indicate they need to purchase the fund immediately and it is not possible to deliver the Fund Facts to the investor prior to the sale occurring. As a result, there is likely no need for this exception. Use of this exception could be indicative of high pressure sales tactics and should be closely monitored for such behaviour.

2.2. FAIR Canada recommends that securities regulators conduct compliance sweeps following implementation of the Stage 3 of Point of Sale to see if the use of the exception is, in fact, the result of an investor driven request and is being used appropriately or whether it is being abused.

3. Pre-Authorized Purchase Plan Holders Need Delivery of Fund Facts Upon a Material Change to the Fund

3.1. FAIR Canada agrees with the proposed regime for pre-authorized purchase plans which will not require pre-sale delivery of the Fund Facts to subsequent purchases of mutual funds with the following proviso: if there is a material change to the fund, especially with respect to risk, then the updated Fund Facts document should be required to be delivered to the investor and the material change(s) should be brought to the attention of the investor. Otherwise, the investor may continue to make contributions into the fund unaware that the fund has changed in a material respect.

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[1] Joint Forum of Financial Market Regulators, "Proposed framework 81-406: Point of sale disclosure for mutual funds and segregated funds" (June 15, 2007), prepared by: Canadian Securities Administrators and Canadian Council of Insurance Regulators, at page 2.

[2] Research Strategy Group, "Fund Facts Document Research Report" (October 25, 2006), prepared for the Ontario Securities Commission, at page 68, online: <http://www.jointforum.ca/en/init/point_of_sale/Appendices_4-5.pdf>.

[3] *Supra*, note 1 at page 6.

4. Compliance and Enforcement of Fund Facts Pre-Sale Delivery Requirements Important

4.1. Currently, in accordance with Stage 1 of the Point of Sale initiative, mutual funds are required to file a Fund Facts and make it available on the mutual fund's or mutual fund manager's website. Despite this requirement, FAIR Canada notes that it is often difficult to locate the Fund Facts for a given mutual fund on the mutual fund's or mutual fund manager's website. FAIR Canada urges securities regulators to ensure compliance with the spirit of the rule and ensure that the Fund Facts documents are made easy for investors to locate.

4.2. Further, FAIR Canada stresses that pre-sale delivery will only have the intended effect if in fact it occurs. Therefore, dealers must have effective compliance regimes to ensure that pre-sale delivery does, in fact, occur and securities regulators must also have effective compliance and enforcement regimes to ensure that dealers comply with the requirements or have enforcement action taken against them if they fail to do so.

5. Investor Testing After Implementation of Point of Sale Recommended

5.1. FAIR Canada recommends that investor testing of the Fund Facts be conducted subsequent to implementation of pre-sale delivery to ensure that the Fund Facts document is meeting its disclosure objectives, assisting investors in their decision-making process, and that it is understood and used by investors as anticipated and expected.

5.2. In FAIR Canada's view, an essential benefit of the Fund Facts document is that it will allow investors to compare the risks, costs, benefits, and other characteristics of different mutual funds in order to make informed investment decisions. However, in light of evidence of heavy reliance by investors on advice they receive from representatives, it remains to be seen what effect Fund Facts will have on investors' decisions. Testing should seek information on how the Fund Facts are used in the sales process and whether representatives' explanations help investors to better understand the information Fund facts is meant to convey. We encourage the CSA to design its testing with this in mind.

5.3. FAIR Canada also encourages the CSA to consider the comparability of the Fund Facts for a mutual fund with the Fund Facts for other types of investment funds (such as ETFs) when designing Fund Facts for other types of investment funds.

5.4. FAIR Canada is aware of the extensive amount of time that it has taken to reach Stage 3 of the Point of Sale initiative. We recommend that the CSA proceed with this stage and seize the opportunity to refine the Fund Facts document for its intended purpose concurrently with its efforts to implement a point of sale regime for other investment products.

5.5. Such refinement would include reform of the risk section of Fund Facts (please see our comment letter on the proposed risk calculation methodology dated March 12, 2014) and changes to improve clarity and the use of more precise language in order to enhance its effectiveness. We note the following areas may need improvement (although other areas may come to light as a result of the investor testing):

- "What if I change my mind?" section:
  - Harmonization of withdrawal and rescission rights amongst CSA jurisdictions would allow for clear language stating rights of investors. Vague language regarding rights is not helpful and will likely not result in investors exercising those rights.

- "How much does it cost?" section:
  - Do investors understand how representatives get paid upon reading this section? Do they understand how much it will cost to purchase the mutual fund (the initial and ongoing costs)?
  - The language used to disclose conflicts of interest and trailing commissions may not succeed in alerting investors to the fact that their representative does not have an obligation to act in their best interest and that conflicts of interest resulting from the payment of trailing commissions may skew recommendations.
  - The language that states "you don't pay these expenses directly. They affect you because they reduce the fund's returns..." may not be sufficiently clear to convey to investors that, as a result, fund *investors'* returns are reduced. We recommend that the CSA's investor testing include questions to determine whether investors understand the implications of reduced fund returns. If they do not, FAIR Canada recommends that the language be revised to make it clear that fund expenses reduce investors' returns and that investors pay these expenses, albeit indirectly.
  - The language stating "XYZ Mutual Funds waived some of the fund's expenses. If it had not done so, the MER would have been higher." Such language could potentially be confusing or misleading to investors. We recommend that the annual rate of the MER be presented without language indicating that the MER could have been higher; alternatively, we would suggest adding language to the effect that, had the fund waived more of the expenses or managed the fund more economically, the MER would have been lower.
  - The language on F-series Fund Facts documents does not always clearly indicate that the fund is being purchased under a fee-based account.[4] It also does not reference that this fee is to be negotiated with the dealer. It may refer to "fee-for-service" accounts without any explanation of whether this is an account whereby the investor pays for the service and advice of a representative on an hourly basis (fee-for service account) or a fee-based account pursuant to which the investor is charged a percentage of the assets it holds with the representative and his or her dealer (for example, 1% of assets under management) regardless of the amount of time spent by the representative on their account. As a result, total costs to the investor may not be clear (that a 1% charge, for example, may be added to the Fund Expenses) and the investor may be misled as to the type of account they hold.

6. Disclosure Is Not a Panacea

6.1. While disclosure is important, it is not a panacea for all the existing gaps in financial consumer protection. We caution regulators against relying solely on disclosure, and encourage continued progress on initiatives aimed at bolstering protection for retail financial consumers such as implementing a statutory best interest standard and banning embedded trailing commissions.

[4] For example, see the Fund Facts document for Fidelity Canadian Growth Company Fund, Series F, available online at http://www.fidelity.ca/cs/Satellite/doc/FF_CG_F_en.pdf.

FAIR Canada recommends that members of the CSA consider the findings made in the area of behavioural economics, both in terms of designing Fund Facts documents for mutual funds and other investment funds such as ETFs, and also in considering how to ensure adequate investor protection.

7. Understanding Mutual Funds Brochure Requires Reworking to be Useful

7.1. It is our expectation that the Fund Facts document will encourage retail investors to ask more questions about their investments, and we endorse the idea of the CSA providing an unbiased brochure for more information. The CSA should either update or rewrite the "Understanding mutual funds" brochure as it is our understanding that it was originally developed before the point of sale project began. The brochure should be designed so that it can be used to help investors to understand mutual funds and the information contained in the Fund Facts document as well as provide, in plain language, information explaining compensation structures, different fee models, and any potential inherent conflicts of interest. Likewise it should explain that mutual funds are not insured by the Canadian Insurance Deposit Corporation, how costs impact the risk of a fund, and how costs impact long term performance (the best predictor of an investment fund's returns are its expense ratio rather than its past performance[5]). The brochure's use of language should be consistent with that of Fund Facts - for example, the term "representative" should be used rather than "advisor" as is currently used.

8. Transition Period

8.1. A transition period of one-year following the effective date of the Proposed Amendments seems unduly long but in no event should it be further extended while other issues are being determined, such as the risk calculation methodology.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Neil Gross at 416-214-3408 (neil.gross@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,

Canadian Foundation for Advancement of Investor Rights

[5] Russel Kinnel, "How Expense Ratios and Star Ratings Predict Success" (August 9, 2010), available online at: <http://news.morningstar.com/articlenet/article.aspx?id=347327>.