



Canadian Foundation *for*
Advancement *of* Investor Rights
Fondation canadienne *pour* l'avancement
des droits *des* investisseurs

October 5, 2016

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RE: CSA Notice and Request for Comment – Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, National Instrument 33-109 *Registration Information and Related Forms* RE: Report on Charges and Other Compensation

FAIR Canada is pleased to offer comments on the CSA Notice and Request for Comment – Proposed Amendments to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations*, National Instrument 33-109 *Registration Information and Related Forms* (the “Notice”). Specifically, FAIR Canada is pleased to offer comments on the proposed changes to s. 14.17 of National Instrument 31-101 and the requirement to disclose non-cash incentives and embedded fees as part of the annual report on charges and other compensation.

FAIR Canada is a national, non-profit 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.

1. **Executive Summary**

Non-Cash Incentives

- 1.1. Compensation structures containing monetary and non-monetary inducements are in conflict with the interests of clients and undermine the objectivity of advisors. FAIR Canada does not think the CSA's proposals for additional disclosure of conflicts of interest will materially help protect investors.
- 1.2. Non-cash incentives should be addressed through a broad and comprehensive approach to prohibiting conflicted remuneration. Simply disclosing the existence of non-cash incentives will not address the root cause of the problem, as disclosure is not an effective mechanism to address conflicts of interest. While potentially useful in making important information available to investors, such disclosure cannot be the main mechanism to address the investor protection concerns associated with non-cash incentives.

Embedded Fees

- 1.3. FAIR Canada sees value in improving disclosure for investors and appreciates that it may be beneficial for consumers if disclosure is expanded beyond CRM2's requirements so that investors know the total costs of managing their investments (including the embedded fees - for example, management fees - associated with products that have been sold to them). FAIR Canada believes, however, that the impetus for disclosure should always be driven by what is in the investor's best interest.
- 1.4. Any expansion of disclosure must ensure that (i) the expanded disclosure is tested with investors (and this testing is made public) to ensure it is meaningful, comprehensible and in their best interest; and (ii) that all registrants be subject to the same requirements so that investors can meaningfully compare the reports they may receive from various firms, regardless of which regulator oversees them.

2. Eliminate Conflicts of Interest: Disclosure is Not the Answer to Conflicted Remuneration

- 2.1. Compensation structures containing monetary and non-monetary inducements are in conflict with the interests of clients. When advisors, dealers, financial service firms or their representatives ("financial service providers") receive an incentive for selling certain products to clients, or bonuses for meeting certain sales targets, a misalignment between the interests of dealers and registrants occurs vis a vis their clients, and the objectivity of advisors is undermined. FAIR Canada is firmly of the view that these conflicts of interest are pervasive and cause harm to the market and investors, and that simply disclosing the existence of a conflict does not fix the problems.
- 2.2. FAIR Canada does not think the CSA's proposals for additional disclosure of conflicts of interest will materially help to protect investors or encourage healthy competition. We urge the CSA to review the extensive research which shows that disclosing conflicts of interest is not an effective way to protect investors: investors do not understand conflicts of interest or how to appropriately factor the impact of a conflict of interest into their evaluation of investment recommendations; disclosing conflicts of interests has been found to have unintended effects that often make matters worse for the investor; disclosing conflicts of interests may lead advisors to unconsciously provide biased advice; and allowing conflicts of interest to continue can create systemic and structural problems (preventing effective competition) that harms the

market as well as investors¹.

- 2.3. Regulators and governments need to ensure that financial service providers who are relied upon to help further consumers' interests (for example, to help them to adequately save for retirement or save for their children's education) have the ability to provide objective, unbiased professional advice. This requires ensuring that financial service providers are not permitted to receive conflicted forms of remuneration. Only incentives and fee structures that are aligned with consumers' interests should be permitted.
- 2.4. The harm caused by conflicts of interest must be addressed head on if we are to achieve a situation where clients are better off as a result of engaging with the financial services sector. The bottom line is that, in light of significant conflicts of interest, disclosure as the "go-to" solution does not work and hurts the financial outcomes of those it is intended to protect.²
- 2.5. FAIR Canada is strongly of the view, in light of the evidence, that disclosure is insufficient to address the problems caused by conflicts of interest in the financial sector. The best solution is to eliminate conflicts of interest to the greatest extent possible.³
- 2.6. While disclosure may make regulators and even those who are regulated feel like they have taken action to remedy the situation, the reality is far from it. We cannot ignore the fundamental problems created by conflicted remuneration. Rather, as has been recognized in many other jurisdictions (Australia, the United Kingdom, Europe), the solution is to address conflicted remuneration. This is a necessary step in moving to a framework where financial advice can be provided in the client's best interest. It is simply illogical to expect advice to be provided in the client's best interests when the financial service provider is in a business model where he/she is being asked to serve two masters.
- 2.7. Failure to address these fundamental conflicts that have been identified and empirically shown to exist in Canadian capital markets⁴ would be a failure to fulfill the mandate of provincial securities commissions: that of providing protection to investors and fostering fair and efficient capital markets.
- 2.8. The solution is simple: rather than have a rule that requires advisers, dealers and their financial service providers to tell financial consumers that they may get a commission for

¹ See FAIR Canada's submission CSA Consultation Paper 33-404 "Proposals to Enhance the Obligations of Advisers, Dealer, and Representatives Toward their Clients" at paragraphs 2.26 to 2.49, available online at: <http://faircanada.ca/submissions/fair-canada-comments-on-proposed-best-interest-standard-and-proposed-targeted-reforms/>

² Robert A. Prentice, *Moral Equilibrium: Stock Brokers and the Limits of Disclosure* (2011) *Wisconsin Law Review* 1059

³ Behavioural science research supports the conclusion that disclosure is beneficial where an absence of conflicts of interest is what's being disclosed; but the research does not indicate that disclosure is otherwise beneficial. See: Sunita Sah and George Loewenstein, "Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest", (2103) *Psychological Science*, 575; online: <https://www.cmu.edu/dietrich/sds/docs/loewenstein/NothingDelcare.pdf>.

⁴ As noted by Professor Cumming, Sofia Johan and Yelin Zhang, "A Dissection of Mutual Fund Fees, Flows, and Performance". Previous research has been completed in this area by many others. See *Frequently Asked Questions about the Dissection of Mutual Fund Fees, Flows and Performance*, page 4 and footnote 1, online at: http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20160209_81-407_faq-dissection-mutual-fund-fees.pdf; See also The Brondesbury Group, *Mutual Fund Fee Research*, (2015) (prepared for the Ontario Securities Commission on behalf of the Canadian Securities Administrators) at 13 to 18, online: http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20150611_81-407_mutual-fund-fee-research.pdf.

selling a certain type of product or receive a bonus or a referral fee, promotion or other incentive, there should be a rule that prohibits advisers, dealers and their financial service providers from acting other than in their clients' best interests and therefore prohibits them from receiving conflicted remuneration and requires them to avoid conflicts of interest. In this manner, they will actually be able to provide advice that is objective and unbiased and that puts the interests of the client first.

- 2.9. FAIR Canada therefore calls on the CSA to prohibit all types of inducements (both monetary and non-monetary) that give rise to conflicted remuneration and harm investors as well as our capital markets. This is the only effective way to address conflicts of interest and ensure that investors are able to receive objective advice regarding their investments.

3. Interim Step – Investor Testing and Resulting Disclosure of Non-Cash Incentives and Embedded Fees

Non-Cash Incentives

- 3.1. Clients have a right to know about the incentives their dealer or advisor will receive as a result of the sale of certain products. This should include all non-cash incentives. Therefore, as part of an interim step, FAIR Canada supports the introduction of specific disclosure showing clients where and when cash and non-cash incentives are paid to financial service providers, provided testing is done beforehand to ensure the efficacy of this disclosure and the results of such testing are made public. FAIR Canada therefore supports the testing of the additional disclosure as set out in the Notice and, if it proves efficacious, disclosing the information with the understanding that (i) these measures are to be interim steps, and (ii) the CSA must work to expeditiously eliminate conflicts of interest by prohibiting conflicted remuneration.
- 3.2. FAIR Canada supports the addition of the requirement that, where a firm or its representatives received or will receive incentives not captured by the existing disclosure provisions, the annual report must specifically list all additional sales incentives.
- 3.3. FAIR Canada also supports the testing of the additional requirement to include prescribed text in the annual report setting out the following wording (as amended by FAIR Canada - changed wording in italics): "In addition to the payments specified in this report, [the firm] or its representatives may *also* receive other sales incentives related to the securities that you have purchased through us *which are: [specify the sales incentives]*. These incentives can influence representatives to recommend one investment over another *and not consider your best interest in what they have sold you.*"
- 3.4. FAIR Canada stresses that this additional disclosure must be seen as an interim measure only. It is imperative that the CSA work to eliminate conflicts of interest by prohibiting conflicted remuneration.

Embedded Fees

- 3.5. FAIR Canada is supportive of initiatives that seek to continuously review disclosure to ensure that investors are presented with meaningful and comprehensible information that is in their

best interest⁵.

- 3.6. While disclosure of total costs of managing a client's investments (including the embedded fees such as management fees and operating costs associated with mutual funds) could be helpful to investors, FAIR Canada notes that it is not clear whether investors' understanding of costs (including how much they have paid for their financial advisor's advice) would be diminished or improved through adding these other costs to the existing cost disclosure requirements. This is a vitally important question to know before making any such changes. Therefore, potential expanded disclosure needs to be tested with investors (and this testing should be made public) to ensure it is meaningful, comprehensible and in their best interest.
- 3.7. We fully support the commitment that regulators have made to the provision of this crucial financial information to financial consumers. Financial intermediaries (i.e., investment dealers) have a responsibility to ensure that the cost disclosure and performance reports are produced for investors in a manner that is clear and comprehensible.
- 3.8. In addition, any future changes to disclosure, if deemed in the best interests of investors, should be required of all registrants in all regulated investment-related activities so that investors can meaningfully compare the reports they may receive from various firms, regardless of which regulator oversees them.

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 416-214-3442/marian.passmore@faircanada.ca.

Sincerely,



Canadian Foundation for Advancement of Investor Rights

CC: British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission

⁵ See FAIR Canada's letter to the MFDA in response to the Request for Comment: Report on Charges and Compensation – Consultation Regarding Cost Reporting for Investment Funds, (March 10, 2016), available online at: <http://faircanada.ca/submissions/fair-canada-comments-on-mfda-consultation-regarding-cost-reporting-for-investment-funds/>

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Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon Territory
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