



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

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**RE: Canadian Securities Administrators (“CSA”) Consultation on the Option of Discontinuing Embedded Commissions – Consultation Paper 81-408**

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FAIR Canada is pleased to offer comments on the CSA’s Consultation Paper 81-408 regarding the option of discontinuing embedded commissions (“Consultation Document”).

FAIR Canada is a national, charitable organization dedicated to putting investors first. As a voice for Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit [www.faircanada.ca](http://www.faircanada.ca) for more information.

### **Executive Summary**

1. FAIR Canada, on behalf of Canadians, has pressed for the adoption of a statutory best interest standard and reforms that will prevent or avoid conflicts of interest including the removal of embedded commissions (especially trailing commissions and deferred sales charges (“DSCs”)) paid by investment fund managers. These changes are needed so that Canadian investors can receive professional objective advice free from damaging conflicts of interest. Advice needs to be focused on what is best for investors, not what is best for the investment fund manufacturers, financial services representatives and their dealer firms.
2. FAIR Canada supports the elimination of embedded commissions. Embedded commissions in investment products produces a system of inherent conflicts of interest that subvert or subordinate

the interests of investors to the interests of dealers, individual registrants and investment fund manufacturers. The result is that investor outcomes and market efficiency are harmed. In other words, the current mutual fund fee structure results in millions of Canadians not receiving objective advice and being sold suboptimal products.<sup>1</sup> Canadians receive product recommendations driven more by payments their advisor and her firm will receive, instead of what would be best for the consumer. This must change.

3. Canadians simply cannot save what they otherwise would have, given the impact of embedded commissions. They are not provided with advice they need and expect to receive. At best, ordinary Canadians end up with significantly less available for their retirement or for their children's education and have less to contribute to the Canadian economy. At worst, Canadians lose their hard-earned capital through having accepted the "advice" of registrants, having been better off not seeking out the registrant's "advice". This is a concern to all Canadians as our economy and society suffers as a result.
4. It is estimated that Canadians are charged over \$5 billion in trailing commissions annually<sup>2</sup>, with Canada being amongst the highest mutual fund fee jurisdictions in the world.<sup>3</sup> It also has far more actively managed funds than in other jurisdictions (including the UK and USA ) with 87% of investment fund managers offering actively managed funds that have products with negative alphas (i.e. poor performance), with only 1.5% of mutual fund assets held passively.<sup>4</sup>
5. FAIR Canada believes that banning embedded commissions (including DSCs) from all investments is an essential step to address the harms that have been identified, and to improve financial outcomes for Canadians. We define "embedded commissions" as used throughout this submission to mean remuneration by a third party (for example an investment fund manager) to dealers (which may or may not also be paid to their representatives) in respect of the sale of an investment (whether it be mutual funds, exchange traded funds, structured products, exempt market products or other types of securities) to an investor.
6. In addition, other forms of compensation arrangements that harm consumers should also be addressed. What is needed is the avoidance of conflicted compensation arrangements rather than the permissive world of "managing" conflicts that firms now inhabit, which allow for the creation of personnel and compensation policies and practices that create conflicts. A real focus on this area is urgently needed. Resources to implement rules, and guidance to ensure conflicts are avoided – as well as effective compliance oversight and enforcement – are needed.
7. FAIR Canada believes that a ban on embedded commissions should be undertaken with a ban on other

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<sup>1</sup> The MFDA channel alone has 8.9 million Canadian households (or 56% of Canadian households) and it is estimated that 12 million Canadians own mutual funds.

<sup>2</sup> Douglas Cumming, "Blowing smoke on trailer fees: Fees harm investors. Here are the facts" (5 October 2016), online: <<http://www.moneysense.ca/save/investing/blowing-smoke-on-trailer-fees/>>.

<sup>3</sup> As noted in the Consultation Paper, such studies include: B.N. Alpert and J. Rekenhaller, "*Morningstar Global Fund Investor Experience 2011* (March 2011), online: <<https://corporate.morningstar.com/us/documents/ResearchPapers/GlobalFundInvestorExperience2011.pdf>>; A. Khorana, H. Servaes, and P. Tufano, *Mutual Fund Fees Around the World* (July 23, 2007), online: <<http://faculty.london.edu/hservaes/rfs2009.pdf>> and more recently B. Alpert, P. Justice, A. Serhan, and C. West "Global Fund Investor Experience Study" (June 2015), online: <<https://corporate.morningstar.com/US/documents/2015%20Global%20Fund%20Investor%20Experience.pdf>>.

<sup>4</sup> Consultation Document at 42. This number excludes ETFs.

forms of conflicted compensation structures that have been identified. Incentives that distort advice and subvert the interests of consumers should all be addressed.

8. FAIR Canada calls for the immediate elimination of embedded commissions from investment products sold at discount brokerages given that IIROC Dealer Member Rules do not permit discount brokerages to provide recommendations.<sup>5</sup> FAIR Canada recommends that all firms offering a particular mutual fund be required to offer the “F” class version of the fund at discount brokerages. FAIR Canada is astounded that the CSA has not done this to date.
9. The benefits of eliminating embedded commissions include:
  - (i) Reduction in fund series and in fund fee complexity - the fund fee structure will be simplified and made more transparent;
  - (ii) Increased price competition and decrease in fund management costs;
  - (iii) New lower-cost product providers may enter the market (reduce barriers to market entry and increase price competition);
  - (iv) Shift in product recommendations to lower-cost and passively managed products including exchange traded funds;
  - (v) The market will innovate including through offering different forms of direct payment arrangements and through the use of fintech and online advice (robo advice) so that various consumer segments are served (including those with less assets);
  - (vi) Increase in transparency to the consumer as to what they pay as product costs (management fees and operating expenses of the fund) as opposed to what they pay for “advice” and services of the dealer/representative, which will better allow consumers to assess value and control such costs;
  - (vii) Advisors and their firms will no longer be incented by higher trailing commissions and fund managers will have to compete based on performance rather than on the basis of paying higher trailing commissions;
  - (viii) Ability to comparison shop – greater transparency should allow consumers to know, before they speak with a firm/representative and certainly before they enter into a relationship, what the cost will be for advice and services (and what those services and advice include (and do not include)) so as to compare the costs and services/advice of different firms (and their representatives);
  - (ix) Consumers will be able to assess the value of any services and advice they pay for against the costs they incur, on an ongoing basis, rather than simply reviewing the amount of trailing commissions and other costs they currently incur annually as a result of the required cost

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<sup>5</sup> See IIROC Dealer Member Rules 3100 and 3200 and, in particular, Dealer Member Rules 3200(3)(a).

reporting and performance reporting documents (CRM2 Statements);

- (x) Quality of the advice provided should improve and given product bias should be reduced. Business models should be capable of focusing on advice such as creating and following a budget, prioritizing short and longer term goals, paying down debt, and saving in the most tax efficient manner in light of income etc., rather than simply focusing on product sales; and
- (xi) Enhance the professionalism of the financial services industry and enhance public trust in the industry and financial markets, which would benefit both investors, dealers and representatives.

10. *Disclosure Not Effective to Protect Consumers or Ensure Well Functioning Market* - Regulators and stakeholders must come to grips with the reality that disclosure is not an adequate solution to ensure effective financial consumer protection and simply will not address the problems identified. CRM2 and Point of Sale are worthwhile initiatives but do not address the compensation structures that lead to biased and tainted advice.
11. The Proposed Targeted Reforms will also not address the concerns with the relationship between dealers, advisers, and their representatives vis a vis their clients because they take existing business models as “inevitable” or “normal”, and blithely assuming them to be manageable (typically by disclosure). FAIR Canada is strongly of the view, in light of the independent evidence, that disclosure is insufficient to address the problems caused by conflicts of interest in the financial sector *even if* that disclosure is improved to so that it is “prominent, specific and clear” and tries to be “meaningful” to the client so that the client “fully understands the conflict including the implications and consequences of the conflict for the client”<sup>6</sup> and even if dealers and their representatives complied with the rules (which they often do not).<sup>7</sup> Avoidance of conflicts is the answer.
12. Industry has failed to address the problems associated with conflicted compensation on their own – it has failed to increase proficiency adequately or avoid biased compensation models.
13. Professor Cumming’s report found that proprietary products also harmed investors and harmed market efficiency. The report explained that affiliated dealer flows result in material conflicts of interest that are detrimental to mutual fund investors over the long-term.<sup>8</sup> Therefore, FAIR Canada continues to recommend that a clear picture be provided to consumers. Firms that only sell affiliated dealers products should not be able to hold out that they provide advice in the best interests of

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<sup>6</sup> Canadian Securities Administrators, Consultation Paper 33-404: *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Towards their Clients* (28 April 2016), 39 OSCB 3947 at 3957 [Consultation Paper 33-404].

<sup>7</sup> The OSC’s Mystery Shopping Report demonstrated that representatives did not comply with their regulatory obligations in disclosing conflicts of interest. Verbal disclosure about conflicts of interest was provided in connection with the discussion of fees and charges in only 4% of cases (2 of 49 shops) and in connection with the discussion of advisor compensation, in only 9% of cases (2 of 22 shops). See OSC Staff Notice 31-715, *Mystery Shopping for Investment Advice: Insights into Advisory Practices and the investor experience in Ontario*, at page 29, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category3/20150917-mystery-shopping-for-investment-advice.pdf>.

<sup>8</sup> Professor Douglas Cumming, *Frequently Asked Questions about the Dissection of Mutual Fund Fees, Flows and Performance Report* (2016) at 7, online: [http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp\\_20160209\\_81-407\\_faq-dissection-mutual-fund-fees.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20160209_81-407_faq-dissection-mutual-fund-fees.pdf) [Cumming Q&A].

consumers and their representatives should be restricted to the title “salesperson”.

14. *Banks and Insurers Need An Open Shelf and Oversight of Compensation Arrangements* - FAIR Canada further recommends that if bank branches or affiliated dealers of insurers want to provide advice in the best interests of consumers they should be required to have an open shelf. This should be monitored on a comprehensive basis so that sales incentives, compensation grids, performance targets or reviews or internal transfer payments don't favour the sale of affiliated/proprietary products over others, to the detriment of clients. FAIR Canada also recommends that a cross-subsidization rule be examined in order to ensure a competitive landscape and not provide an undue advantage to vertically integrated firms.
15. *Borrowing to Invest and Harmful Incentives* - FAIR Canada continues to recommend that securities regulators prohibit dealers and their advisors from obtaining any types of fees or commissions in respect of investments made from borrowed funds so as to prevent unsuitable recommendations to borrow to invest in securities, such as mutual funds. This should be the case whether the account is fee based or otherwise. For fee based accounts, dealers should be precluded from charging asset based fees on monies that are borrowed for investment purposes, as in Australia.<sup>9</sup>
16. *Referral Fees Incent Harmful Leverage Strategies* - In addition, referral fees from lenders to dealers and their representatives that incent representatives to recommend leveraging strategies should be prohibited.
17. We recommend that the CSA require the types of advice options and the range of investments available at a dealer be disclosed in plain language on the main page of the dealer's website so that consumers can easily shop around and make comparisons.

*Payment Options – FAIR Canada Agrees with Direct Pay Arrangements*

18. Various studies suggest that the further removed a transaction is from cash, the less price-sensitive consumers are about the costs. FAIR Canada disagrees that payment for advice be permitted to be automatically deducted from the consumer's account by the investment fund manager. We believe that this arrangement could encourage the dealer and its representatives to continue their relationships with certain investment fund managers when this may not be in the best interest of the client. The dealer and its representative may continue to offer certain mutual funds rather than recommend lower cost ETFs for example. The separation of the relationship between advice and product recommendations may be impeded by such continued relationships. Adoption of this type of system may create problems of a similar nature to the one it is trying to solve.
19. FAIR Canada recommends that the CSA determine other alternative forms of payment such as keeping a portion of the client's funds in a high interest savings account or money market funds to pay for ongoing advice received. This would ease the “pain” associated with writing a cheque while not creating relationships that lead to conflicts that harm consumers.

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<sup>9</sup> Australian Securities and Investments Commission REP 28, “Response to submissions on CP 189 Future of Finance Advice: Conflicted remuneration” (4 March 2013), online: < <http://asic.gov.au/regulatory-resources/find-a-document/reports/rep-328-response-to-submissions-on-cp-189-future-of-financial-advice-conflicted-remuneration/> > [ASIC Response].

20. *Regulatory Arbitrage* - FAIR Canada continues to recommend that the risk of regulatory arbitrage with segregated funds, principal protected notes, index linked GICs or other investment products be addressed by: (i) determining that advice not to invest in a security (in favour of a non-security) is advice about securities and is subject to a best interest standard; (ii) amend the definition of “securities” so that segregated funds are no longer exempted from provincial securities acts; and (iii) preclude acceptance of third party commissions in respect of investment products regardless of whether a security or not. We also support the measure noted in the Consultation Document aimed at having insurance regulators harmonize their regulatory frameworks so that mutual funds, segregated funds and other investment products are subject to the same rules including a requirement to remove embedded commissions.
21. *Internal Transfer Payments* - FAIR Canada recommends that internal transfer payments between affiliated dealers not be allowed to circumvent the prohibition of embedded commissions through another means.
22. *Other Dealer Compensation Payments* - FAIR Canada recommends that the CSA not permit conflicted dealer compensation payments that lead to incentives and behaviours subverting the interests of consumers. All compensation arrangements (referral fees, underwriting commissions and other sales incentives, monetary and non-monetary payments in respect of marketing and educational practices related to NI 81-105) should be examined. We make specific recommendations regarding these issues below.
23. *Need for Unbiased, Professional Advice* - FAIR Canada notes that Canada already has an advice gap. Today, not all Canadians with investments “can obtain the amount of advice they desire at the price they are willing to pay”.<sup>10</sup> Canadians who have embedded mutual funds and other embedded investments are either getting no advice (including those at discount brokerages), or getting sold products that are suboptimal through biased commission structures, which leads to market inefficiencies and harm to consumers. Public policy should remove structures that impede a properly functioning market. They should also facilitate transparency so that consumers can assess value. Canadians expect and deserve unbiased, professional advice, but the embedded commission structure undermines the ability of the financial services industry to provide what most would consider true, or objective, financial advice.
24. *Transition* - FAIR Canada believes that a Transition Date of two years is more than sufficient for all affected parties to ensure a successful transition and complete all necessary transition steps. We favour a defined transition period as this would provide more clarity for consumers who wish to explore alternatives and is also a more simple approach for all participants.
25. FAIR Canada makes recommendations in this submission to improve the CSA’s reform proposal in order to improve the ability of Canadians to receive advice that it is in their interests and encourage effective competition for the benefit of the investing public. The ban on conflicted compensation (including embedded commissions) will foster fair and efficient markets and enhance investor protection.

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<sup>10</sup> This is how the “advice gap” is defined at page 62 of the Consultation Document.

26. We urge the CSA to move forward with this expeditiously.

27. *Best Interest Standard* - FAIR Canada also urges all CSA jurisdictions to adopt a statutory best interest standard as set out in our submission on CSA 33-404 (Proposed Best Interest Standard and Proposed Targeted Reforms) along with the accompanying reforms we believe are needed (increasing proficiency and restricting the use of titles).<sup>11</sup> For those jurisdictions that have indicated they will move forward with a best interest standard, they should move forward quickly to prohibit embedded commissions - a best interest standard should include a prohibition against the acceptance of embedded commissions and other conflicted compensation..

### **1. Embedded Commissions Harm the Market and Harm Investors – Key Investor Protection and Market Efficiency Issues Raised by Mutual Fund Fees and Related Evidence**

1.1. As a result of the CSA commissioned research, we now have undeniable empirical evidence based on *Canadian* investment fund data that embedded commissions impact investor outcomes and market efficiency negatively. The CSA initiated independent third party research in late 2013 to assess the impact of commissions and embedded fees on mutual fund flows in Canada. Professor Douglas J. Cumming, Professor of Finance and Entrepreneurship and the Ontario Research Chair at the Schulich School of Business, York University conducted the research and released his findings in October 2015.

1.2. As explained by CSA Consultation Paper 33-404 (and in the Consultation Document), Professor Cumming's "...paper found that conflicts of interest specifically sales commissions and trailing commissions paid by fund companies (embedded registrant compensation), dealer affiliation and the use of DSC arrangements materially affect representative/dealer behaviour to the detriment of investor outcomes and market efficiency. While generally, mutual fund flows should (and do) bear a relationship to the fund's past performance, the research found that:

- The payment of embedded registrant compensation and the use of DSC arrangements materially reduce the sensitivity of fund flows to past performance and increase the level of fund flows that have no relationship to performance;
- The converse is also true: fund flows for mutual fund series that do not pay embedded registrant compensation (fee-based series) are more sensitive to past performance;
- as embedded registrant compensation increases there is an associated reduction in future outperformance before fees; and
- fund flows from affiliated dealers of the investment fund manager show little to no sensitivity to past performance, and this lack of sensitivity is also associated with reduced future outperformance before fees."<sup>12</sup>

1.3. In other words, trailing commissions and DSCs charges warp investment flows by letting

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<sup>11</sup> See FAIR Canada's submission on CSA 33-404, available online at <http://faircanada.ca/wp-content/uploads/2016/10/160930-Final-FAIR-Canada-Submission-33-404-Best-Interest.pdf> [FAIR Submission on 33-404].

<sup>12</sup> Consultation Paper 33-404, *supra* note 6 at 3951.

something other than what's best for the investor drive sales, and this channels many investors toward suboptimal funds. Trailing commissions and DSCs harm investors and market efficiency by facilitating deteriorations in fund performance. Professor Cumming findings were consistent with previous research conducted on non-Canadian fund data.

- 1.4. **FAIR Canada believes that banning embedded commissions (including DSCs) is an essential step to address the harms that have been identified and to improve financial outcomes for Canadians.** It is not simply a “potential option” as described in the Consultation Document and in CSA Staff Notice 81-327<sup>13</sup>. It is a necessary step given the information and data we have. Conflicted remuneration, including embedded commissions, must be avoided.

#### ***Understanding How DSCs Harm Consumers***

- 1.5. We know that DSCs are harmful to financial consumers because:

- (i) Prof Cumming's report demonstrates that investments under the DSC option have the least sensitivity to past performance out of all purchase options<sup>14</sup> but nonetheless \$241 billion dollars of assets under management are held in DSC funds (back-end and low load funds) at the end of 2015.
- (ii) Fund investors with little to invest are the most likely to be offered DSC purchase options and some firms primarily offer their clients DSC options. As stated by the CSA, “The dealer will typically choose which purchase options to make available and if multiple options are made available, the representative will choose which of these options are presented to the client depending on their needs and representative's revenue requirements.”<sup>15</sup>

Therefore, recommendations are not being made based on the best interests of the client (or what is most suitable or appropriate for the client) but on the revenue needs of the dealer and its representatives. This makes it clear that investors do not presently have a “choice” at their existing dealer as to whether to choose embedded commissions or pay some other way. Many investors are unaware that they pay trailing commission and if aware, they trust and rely on their dealer and its representatives, with most believing the “advisor” will recommend what is best for them even at the expense of their own commission. Certain “choices” (and not others) are presented or recommended to the client.

- (iii) Investors are often unaware of the redemption fees that apply to DSC funds if sold before the end of the redemption schedule (normally 7 years and 3 years for low load funds). Until recently, there was no regulatory obligation to inform investors when they were sold the fund that if they redeemed before the end of the 7 year period, they would incur redemption fees! Investors do not understand that the dealer/representative gets an

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<sup>13</sup> CSA Staff Notice 81-327 “Next Steps in the CSA's Examination of Mutual Fund Fees” (29 June 2016), online: <[http://www.osc.gov.on.ca/en/SecuritiesLaw\\_csa\\_20150629\\_81-327\\_next-steps-mutual-fund-fees.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20150629_81-327_next-steps-mutual-fund-fees.htm)>.

<sup>14</sup> CSA Consultation Document at 100.

<sup>15</sup> Ibid at 48.



upfront commission when they recommend a DSC fund.

- (iv) *DSCs and Proprietary Mutual Funds* - Investors may be unaware that they cannot move certain proprietary mutual funds in kind from one dealer to another and will be forced to sell the funds if they wish to move dealers. If they are DSC funds, redemption charges will be incurred. This impacts investors negatively and deters effective competition.
- (v) DSCs can incent unsuitable recommendations<sup>16</sup> and can incent dealers and their representatives to promote unsuitable leverage strategies or churning, as can be seen from several MFDA Bulletins<sup>17</sup>, enforcement cases<sup>18</sup>, and OBSI statistics.<sup>19</sup>
- (vi) *DSCs and Seniors* - The MFDA's 2017 Client Research Report indicates it has identified seniors as a particular concern with respect to DSCs<sup>20</sup> and that representatives may be using DSC commissions to finance the cost of their operations to mass market clients.<sup>21</sup> DSCs appear to targeted to the most vulnerable consumers.
- (vii) It is perhaps then, not surprising to read that Canada has a unique reliance on DSCs in its mutual fund market with 20% of mutual fund assets in Canada whereas these options are less than 1% of mutual fund assets in the United States and Europe.

- 1.6. ***In light of the foregoing, FAIR Canada recommends that DSCs are a form of embedded commission (paid at the point of sale) that needs to be prohibited. They are rife with conflicts of interest, target the most vulnerable investors and there is strong evidence of misselling, in addition to the funds themselves being suboptimal.***

### ***Recommending Borrowing to Invest in Mutual Funds Harms Consumers***

- 1.7. Embedded commissions prevent the provision of objective financial advice (including not purchasing an investment). They also encourage harmful activities such as leveraging or using margin to purchase mutual funds and relationships between financial institutions who are lenders and mutual fund manufacturers and dealer firms, so that recommendations are made to

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<sup>16</sup> See Ibid, Appendix A, at 103 to 104.

<sup>17</sup> MFDA Bulletin #0670-C, DSC Sweep Report (18 December 2015), online: < <http://mfda.ca/bulletin/bulletin0670-c/>>; MFDA Bulletin #0705-C, Review of Compensation, Incentives and Conflicts of Interest (15 December 2016), online: <<http://mfda.ca/bulletin/review-of-compensation-incentives-and-conflicts-of-interest/>> [MFDA Bulletin #0705-C]. The 2016 MFDA Report states that the MFDA "...identified compensation structures that provided additional incentives to recommend deferred sales charge ("DSC") funds. We expect firms to properly manage these risks and consider amendments to their compensation structure and we will continue to review compensation structures in our examinations."<sup>17</sup> The MFDA noted compensation grids that could incent representatives to favour DSC Funds or compensation grids where the payout on sales commissions (such as DSCs) was higher than trailing commissions. Both of these structures would "strongly incent" behaviour to generate DSC commissions.

<sup>18</sup> See footnote 174 of the Consultation Document.

<sup>19</sup> OBSI Annual Report highlights persistent issues with DSC funds. See for example, the 2015 Annual Report where fee disclosure such as DSCs are in the top 3 issues that consumers complain about and it is the largest secondary issue they complaint about; online <<https://www.obsi.ca/en/download/fm/500/filename/Annual-Report-2015-1459375786-099e4.pdf>> at 50.].

<sup>20</sup> MFDA Bulletin #0721-C, at 19.

<sup>21</sup> Ibid at 15.

an investor to take out a loan to invest in mutual funds.<sup>22</sup>

- 1.8. ***FAIR Canada continues to recommend that securities regulators prohibit dealers and their advisors from obtaining any types of fees or commissions in respect of investments made from borrowed funds so as to prevent unsuitable recommendation to borrow to invest in securities, such as mutual funds.*** This should be the case whether the account is fee based or otherwise. For fee based accounts, the fee should be calculated based on net assets under management – dealers should be precluded from charging asset based fees on monies that are borrowed for investment purposes, as in Australia.<sup>23</sup>
  
- 1.9. ***Referral Arrangements Between Lenders, Dealers and Representatives Take Advantage of Consumers*** – The CSA Consultation Document states as follows:
 

“Recommendations that clients borrow to invest in funds on a DSC basis enable the dealer and their representative to increase the total compensation they can earn from the investment. Specifically, they may receive a referral fee from the financial institution in connection with their client’s loan in addition to the 5% upfront commission (plus the ongoing trailing commission) they may receive from the investment fund manager on the purchase transaction.”<sup>24</sup>
  
- 1.10. ***FAIR Canada recommends that referral fees from lenders to dealers and their representatives should be prohibited as they incent borrowing to invest strategies that are not in a consumer’s interests and can lead to devastating harm.***
  
- 1.11. FAIR Canada commends the CSA for having conducted the independent research of mutual fund fees and for the thoroughness of the background data and the regulatory impact analysis found in the Consultation Document. The Consultation Document does a very good job of going through the investor protection and market efficiency issues related to embedded commissions. For further explanation of investor protection concerns, please see our best interest submission at pages 4 through 18.
  
- 1.12. **However, FAIR Canada does believe that the CSA has been too tentative in its presentation of the research findings on the harms caused by embedded commissions, and its conclusions, given the independent research findings, data and stakeholder input.** It is not simply that embedded commissions “can” “incent investment fund managers to rely more on payments to dealers....and this incentive “can” in turn lead to underperformance; or that it “can encourage a push for higher commission generating funds...which can impair investor outcomes”. The Cumming research demonstrates empirically and categorically that it “does”. The harmful effect of these fees is beyond doubt.
  
- 1.13. Similarly, if embedded commissions are not banned, investment fund managers will continue to place greater emphasis on payments to dealers than on performance to gather and preserve

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<sup>22</sup> See FAIR Canada’s letter to CSA dated October 26, 2011, online: <<http://faircanada.ca/wp-content/uploads/2015/12/111026-letter-to-CSA-re-Leverage.pdf>>.

<sup>23</sup> ASIC Response *supra* note 9.

<sup>24</sup> Consultation Document at 104.

assets under management. The model likely will continue to encourage high fund fees and impair investor outcomes and market efficiency, including effective competition in our market. It is not simply that this *may* occur. Follow the money!

- 1.14. *Industry Misinformation and Biased Reports* - **FAIR Canada also believes that it is incumbent on the CSA to evaluate and assess the research studies and reports that it references.** Sometimes, industry lobbyist groups or others in the financial services industry will resort to misinformation or unfounded critiques of independent research, or put forth flawed empirical studies of their own in an attempt to prevent (or at least delay) change. **We urge the CSA and governments to critically assess industry sponsored research, reports and industry assessments of developments in other jurisdictions.**
- 1.15. For example, the Consultation Document includes a summary of the key academic research that has been conducted in its discussion of how embedded commissions reduce the investment fund manager's focus on fund performance, which can lead to underperformance (conducted by Professor Cumming as well as the study by Susan Christoffersen et al.). In addition, it cites an industry study conducted by Investor Economics (sponsored by the mutual fund lobby group, the Investment Funds Institute of Canada or "IFIC") to state "in contrast to the above research"<sup>25</sup>.
- 1.16. The CSA should also include, or at least footnote, Cumming et al's FAQ that was published by the CSA. The FAQ includes a pointed evisceration of the Investor Economics report. The FAQ comments that the IFIC sponsored report "studies the wrong measure of returns with insufficiently detailed data, and completely incorrect econometric methods that ignore over half a century of econometrics and statistics and has qualitative arguments that only serve to highlight the mistakes with the econometric methods used. Without the necessary econometric underpinnings and data, Investor Economics can say absolutely nothing about the relationship between mutual fund performance and mutual fund flows or about other pertinent factors that may affect those flows."<sup>26</sup>
- 1.17. The reader of the Consultation Document should be made aware of this critique of the industry sponsored research, at a minimum. Ideally, the CSA should indicate its own assessment of the validity of industry led research. To do otherwise, is to suggest that Cumming and Christoffersen's research is not conclusive and that the industry study has some validity, which in our submission it does not.

### ***No Significant Benefits from Embedded Commissions***

- 1.18. The CSA specifically asks if there are any significant benefits to embedded commissions such as access to advice, efficiency and cost effectiveness of business models, and heightened competition that may outweigh the issues or harms of embedded commissions in some or all circumstances.
- 1.19. **FAIR Canada can respond with an emphatic no.** There is no independent evidence that Canadians will not have "access" to advice if embedded commissions are prohibited and we

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<sup>25</sup> Ibid at 100 and footnote 158.

<sup>26</sup> Professor Cumming Q&A, *supra* note 8 at 16.

move to direct pay arrangements. There is no independent evidence that Canadians are better off through any “advice” (really meaning “sales”) received through embedded commissions. However, there is much evidence that the relationship is ridden with conflicts, which leads to harms to investors and the market. Conflicted advice is provided while the consumer is led to believe that the dealer and its representative are acting in the consumer’s best interest. Consumers are not getting the advice that they need, deserve and expect.

- 1.20. In fact, the academic literature suggests that, there is a clear benefit of policy intervention that requires firms to make customers pay directly for advice.<sup>27</sup>
- 1.21. We see no support for the idea that in some circumstances embedded commissions have “benefits” that outweigh the “costs”. Moreover, the question implies that the CSA imports some value to the efficiency and cost effectiveness of business models rather than the efficiency and effectiveness of the market vis a vis the investing public. **Securities regulators do not have as their mandate the protection of business models or the support of a particular level of profitability of the financial industry, especially business models which do not serve consumers and lead to poor outcomes.**
- 1.22. Finally, market efficiency and effective competition are hindered by embedded commissions as found by the independent research, so that part of the question is misguided.
- 1.23. We note that the Consultation Document is quite thorough in going through the studies as to whether people are better off from obtaining conflicted advice.<sup>28</sup> FAIR Canada is concerned that a positive correlation between “advice” (which is undefined in the reports prepared by the investment fund industry lobby groups such as the Investment Funds Industry of Canada (“IFIC”)) and positive outcomes (which are vague in the reports, and consist primarily of increased savings levels) is interpreted to demonstrate that “advice positively and significantly affects the level of savings of individuals”. We note that correlation does not prove cause and effect. **While increased savings may be a positive by-product of obtaining investment advice, it may be due to other factors entirely such as those people who choose to receive advice are already more inclined to save than those who do not seek out advice.**<sup>29</sup>
- 1.24. Any intangible benefits that may be obtained from having a relationship with a representative will not be removed with the removal of embedded commissions. Canadians will still be able to obtain advice and it will improve the quality of the advice received. Moreover, there are other policy alternatives to encourage savings discipline amongst Canadians, which could take advantage of behavioural economics and behavioural insights.

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<sup>27</sup> Roman Inderst and Marco Ottaviani, “How (not) to pay for advice: A framework for consumer financial protection” (August 2011), online: <[http://www.wiwi.uni-frankfurt.de/fileadmin/user\\_upload/dateien\\_abteilungen/abt\\_fin/Dokumente/PDFs/Allgemeine\\_Dokumente/Inderst\\_Download/Finance/How\\_not\\_to\\_pay\\_for\\_advice.pdf](http://www.wiwi.uni-frankfurt.de/fileadmin/user_upload/dateien_abteilungen/abt_fin/Dokumente/PDFs/Allgemeine_Dokumente/Inderst_Download/Finance/How_not_to_pay_for_advice.pdf)> at 4.

<sup>28</sup> See Consultation Document at 105 to 107 and 125 to 129.

<sup>29</sup> Jeremy Burke and Angela Hung, “Rand Study: Do Financial Advisors Influence Savings Behavior?” (2015) online: <[http://www.rand.org/content/dam/rand/pubs/research\\_reports/RR1200/RR1289/RAND\\_RR1289.pdf](http://www.rand.org/content/dam/rand/pubs/research_reports/RR1200/RR1289/RAND_RR1289.pdf)>.

## **2. CSA, IIROC and MFDA Reports on Compensation Practices and Incentives – Need for Avoidance of Conflicts of Interest**

- 2.1. The CSA and SROs have been reviewing or researching the issue of conflicts of interest for several years. These are not “legal” or “technical” conflicts but are structures that create concrete motivations, set from the top of the organization, that encourage behaviours which do not meet existing regulatory requirements, or should not be permitted because they harm investors and confidence in our markets despite not being explicitly prohibited. Last December the CSA, IIROC and MFDA all issued notices<sup>30</sup> (and IIROC released another notice this April<sup>31</sup>) relating to compensation related arrangements and incentive practices. The notices listed a litany of methods that firms have to drive real life behaviours that may, and do, harm clients but that presumably increase profitability or meet the business goals of the firms. The reports document business models whose compensation and personnel arrangements and practices clearly and explicitly incentivize and reward registrant behaviour that benefits the firm at the expense of its clients.
- 2.2. ***FAIR Canada recommends that the CSA, IIROC and MFDA take immediate action to enforce existing rules and take disciplinary proceedings against those compensation arrangements that do not meet current regulatory requirements.*** We are extremely disappointed with the timeliness of compliance oversight and lack of enforcement activity. We fully agree with the letter from the Ontario Securities Commission’s Investor Advisory Panel on this issue.<sup>32</sup>
- 2.3. We believe that all of the following should be a violation of existing conflict of interest rules and the duty to act “fairly, honestly and in good faith”: non-neutral compensation grids that favour the sale of proprietary products, awarding professional titles based on achieving sales targets, higher payouts for selling DSC funds or placing people in fee-based accounts, double dipping wherein people are placed in fee-based accounts but have embedded commission funds within such accounts, and tying a branch manager’s or compliance officer’s compensation to the sales performance of the employees they are responsible for supervising.
- 2.4. ***FAIR Canada recommends that securities regulators make it clear as a matter of urgency what practices and incentives are not permissible in accordance with their statutory mandates. What is needed is the avoidance of conflicted compensation arrangements rather than the permissive world of “managing” conflicts that firms now inhabit, which allow for the creation of personnel and compensation policies and practices that create conflicts harming consumers.*** A real focus on this area is urgently needed. Resources to implement rules, and guidance to

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<sup>30</sup> CSA Staff Notice 33-318, *Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives* (15 December 2016), online: <[http://www.osc.gov.on.ca/documents/en/Securities-Category3/csa\\_20161215\\_33-318\\_incentives.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20161215_33-318_incentives.pdf)> [CSA Staff Notice 33-318]; IIROC Notice, *Managing Conflicts in the Best Interests of the Client* (15 December 2016), online: <[http://www.iiroc.ca/Documents/2016/4dd98e70-f053-4980-bc75-10ceb6f3940d\\_en.pdf](http://www.iiroc.ca/Documents/2016/4dd98e70-f053-4980-bc75-10ceb6f3940d_en.pdf)>; MFDA Bulletin #0705-C, *supra* note 17, online: <<http://mfda.ca/bulletin/review-of-compensation-incentives-and-conflicts-of-interest/>>.

<sup>31</sup> IIROC Notice, *Managing Conflicts in the Best Interest of the Client* (6 April 2017), online: <[http://www.iiroc.ca/Documents/2016/F58C9465-AFC5-42F3-A5D1-6C5BFDF19CF3\\_en.pdf](http://www.iiroc.ca/Documents/2016/F58C9465-AFC5-42F3-A5D1-6C5BFDF19CF3_en.pdf)>.

<sup>32</sup> Letter from the Ontario Securities Commission’s Investor Advisory Panel to the CSA, MFDA, and IIROC re CSA, IIROC, MFDA Reports on Firm Compensation Practices (12 April 2017), online: <[http://osc.gov.on.ca/documents/en/Investors/iap\\_20170412\\_firm-compensation-practices.pdf](http://osc.gov.on.ca/documents/en/Investors/iap_20170412_firm-compensation-practices.pdf)>.

ensure conflicts are avoided – as well as effective compliance oversight and enforcement – are needed.

### **3. Disclosure Will Not Address Harms – CRM2, POS and Proposed Targeted Reforms Won't Address the Problem**

- 3.1. **Regulators and stakeholders must come to grips with the reality that disclosure is not an adequate solution to ensure effective financial consumer protection and simply will not address the problems that have been identified.** CRM2 and Point of Sale are worthwhile initiatives but do not address the compensation structures that lead to biased and tainted advice.
- 3.2. It is simply unworkable to expect dealer firms and their representatives to prioritize the interests of the client ahead of the interests of the firm and/or representative while permitting the harmful conflicted compensation structures (including embedded commissions) to continue. This has not been and will not be effective. Compensation drives behaviour! Regulators and governments need to require that conflicts of interests be avoided wherever possible. We refer you to our thorough discussion of why disclosure of conflicts of interest is not an effective remedy in our submission on CSA Consultation 33-404.<sup>33</sup>
- 3.3. **CRM2** - To be clear, FAIR Canada supports the provision of important information to investors (such as the type of services that the firm and its representatives will offer, the costs for those services, summary disclosure such as fund facts<sup>34</sup> and cost disclosure and performance reporting). However, this does not mean that such disclosure is effective as a mechanism to protect their interests. Disclosure does not work to adequately protect investors from conflicts of interest including the structural harms that have been identified.
- 3.4. As noted by a recent BCSC survey, knowledge of direct fees paid is higher than knowledge of payments made by third parties.<sup>35</sup> From what we know about consumers, their level of trust and reliance on the representative and given behavioural insights, they are not able to take into account the knowledge of the consequences of this disclosure of conflicts of interest from third party payments. FAIR Canada agrees with the analysis in Part 6 of the CSA Consultation Document (at pages 87 to 89) that explains why CRM2 will not make consumers informed decision-makers that will be able to adequately compensate for, and factor in their decision-making, the conflicts of interest inherent in mutual funds with embedded commissions.
- 3.5. Essentially CRM2 forced the industry to disclose to its clients what they are paying in costs and how much they made, but it did not force the industry to behave decently so that clients are not harmed. FAIR Canada itself is still learning the extent and nature of the conflicts present in our financial services industry as a result of the recent CSA and SRO reports on compensation

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<sup>33</sup> FAIR Submission on 33-404, *supra* note 11 at ss. 2.26 to 2.48

<sup>34</sup> We continue to be of the view that the fund fact's risk disclosure is deficient and does not meet international standards.

<sup>35</sup> After receiving the CRM2 statements, 76% agreed with the statement that they knew the "Total amount of fees paid to my [firm type] to operate and administer my investment account in the last 12 months" whereas 59% agreed with the statement that they knew the "Total amount of fees and commissions paid to my [firm type] by other companies because of the investments that I purchased and/or held in the last 12 months". BCSC Investright Survey Report (conducted by Innovative Research Group), "Investor Readiness for Better Investing 2016-2017 Panel Study: Part 2 (26 April 2017), at 19. We note that it is our understanding that the margin of error is such that inferences from the subgroup data is not possible or meaningful.

practices and incentives. How are consumers supported to grasp it all?

- 3.6. **Proprietary Products and CRM2** – Consumers who buy mutual funds from integrated financial institutions (such as a bank or Investors Group) will not know the exact amount of the trailing commission from the Fund Facts document<sup>36</sup> as that document lumps the trailing commission in with the management fee, fixed administrative fee and operating fees as part of the Management Expense Ratio or MER. The document only provides a range and does not disclose that the trailing commission reduces the investors’ return, nor that it may lead the dealer to favour some funds over others given the amount of embedded commissions it will receive.
- 3.7. **CRM2 Does Not Work for Integrated Firms** - In addition, the CRM2 disclosure for those dealers who are regulated by the Mutual Fund Dealers Association of Canada (again the bank branch representatives will be MFDA registrants as will Investors Group representatives) does not require the dealer to disclose the trailing commission amount separately if they receive transfer payments instead of commission revenue and instead may “...disclose total costs paid by the client to the combined corporate entity, which includes revenue earned by the corporate group for both product management and dealer services. This approach would also meet the requirements of Rule 5.3.3.1(f).”<sup>37</sup> Therefore, if the total cost approach is taken, the consumer will not know the amount that it pays in trailing commission. This is an added reason why, especially for integrated financial institutions (and 95% of assets in the MFDA channel are administered by integrated dealers<sup>38</sup>), the CRM2 disclosure will not provide sufficient transparency as to what they are paying in embedded commissions.
- 3.8. **Integrated Firms and Internal Transfer Payments** - In FAIR Canada’s view, if integrated firms are incapable of separating out the trailing commission from the other fees that make up the MER (because the dealer firm does not receive commissions and instead receives internal transfer payments from its affiliate based upon a “management agreement with the corporate group”) then the trailing commission charged to the consumer is really a fiction. Such dealers can make up whatever amount they like as the distribution cost. This is another reason that such embedded commissions should be prohibited because for integrated firms, such commissions do not appear to bear any relationship to distribution costs.
- 3.9. At its most fundamental level, consumers who go to their trusted bank or other trusted dealer firm are not going to be able to be able to unpack all of this information and act rationally to compensate for the conflicts. Such an expectation would be wholly unrealistic.
- 3.10. **The Proposed Targeted Reforms** – The Proposed Targeted Reforms will also not address the concerns with the relationship between dealers, advisers, and their representatives vis a vis their clients because they take existing business models as “inevitable” or “normal”, and blithely assuming them to be manageable (typically by disclosure). FAIR Canada is strongly of the view,

<sup>36</sup> See for example, BMO Mutual Funds Fund Facts (24 April 2017), online: <[http://fundfacts.bmo.com/RetailEnglish/BMO\\_Canadian\\_Small\\_Cap\\_Equity\\_Fund-EN-Series\\_A.pdf](http://fundfacts.bmo.com/RetailEnglish/BMO_Canadian_Small_Cap_Equity_Fund-EN-Series_A.pdf)> and I.G. Investment Management, Ltd. Investors Real Property Fund – Series A Fund Facts, online: <[http://fundexpressweb.rrd.com/investorsgroup/files/en/F011\\_IRPFA.pdf](http://fundexpressweb.rrd.com/investorsgroup/files/en/F011_IRPFA.pdf)>.

<sup>37</sup> MFDA Bulletin #0689-P, Implementation of Requirements under CRM2 Phase 2 Amendments to NI 31-103 – Frequently Asked Questions (FAQs) (13 May 2016), online: <<http://mfda.ca/bulletin/bulletin0689-p/>>.

<sup>38</sup> CSA Consultation Document at 34.

in light of the independent evidence, that disclosure is insufficient to address the problems caused by conflicts of interest in the financial sector *even if* that disclosure is improved to so that it is “prominent, specific and clear” and tries to be “meaningful” to the client so that the client “fully understands the conflict including the implications and consequences of the conflict for the client”<sup>39</sup> and even if dealers and their representatives complied with the rules (which they often do not).<sup>40</sup> Avoidance of conflicts is the answer. While the Proposed Targeted Reforms try to be helpful because much disclosure to financial consumers has obfuscated the nature of conflicts of interest, managing conflicts through disclosure as a solution will not work (see above and our submission on CSA Consultation 33-404 (Proposed Best Interest Standard and Proposed Targeted Reforms) for a detailed discussion).

- 3.11. Alternative solutions that may be suggested by industry stakeholders (who have a lot to gain by maintaining the status quo) such as retaining consumer choice as to whether to continue with an embedded commission compensation model, would necessarily rely on disclosure, which will not alleviate the harm to the market or to investors. Such suggestions have rightly been rejected by the CSA. Disclosure of conflicts of interest, even if the consequences are clearly articulated, will not work and the structural problems, which results in market inefficiency and investor harm, will remain. In addition, the huge benefits to be gained from banning embedded commissions will be lost.
- 3.12. Canadians deserve to receive objective, professional advice that is in their best interests and is not tied to the recommendation of a mutual fund product. Elimination of embedded commissions from mutual funds (and other investment products) is a critically important step to achieving a situation where Canadians are better off as a result of engaging with the financial services sector. It is also a key step in moving toward a best interest standard – a key reform that Canadians expect and deserve, and that is long overdue.
- 3.13. Banning embedded commissions is not a giant leap of faith. Other jurisdictions have successfully implemented a ban of embedded commissions (usually combined with other needed reforms) with positive outcomes for consumers. The United Kingdom (U.K.), Australia and the Netherlands have done so and Europe is set to do so as of January, 2018. The United States is proceeding with implementation of the DOL Rule. We fully agree with the CSA that: “[G]enerally, jurisdictions that have enhanced the advisor’s standards and obligations have eliminated embedded commissions at the same time .... because they have recognized that these payments are one of the main obstacles preventing the advisor from working in the interests of their clients.”
- 3.14. FAIR Canada believes that the proposal to ban embedded commissions is the best method to address the issues and concerns identified by the CSA in the Consultation Document. A best interest standard, with its accompanying ban on embedded commissions and other conflicted

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<sup>39</sup> Canadian Securities Administrators, Consultation Paper 33-404: *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Towards their Clients* (28 April 2016), 39 OSCB 3947 at 3957 [Consultation Paper 33-404].

<sup>40</sup> The OSC’s Mystery Shopping Report demonstrated that representatives did not comply with their regulatory obligations in disclosing conflicts of interest. Verbal disclosure about conflicts of interest was provided in connection with the discussion of fees and charges in only 4% of cases (2 of 49 shops) and in connection with the discussion of advisor compensation, in only 9% of cases (2 of 22 shops). See OSC Staff Notice 31-715, *Mystery Shopping for Investment Advice: Insights into Advisory Practices and the investor experience in Ontario*, at page 29, online: <http://www.osc.gov.on.ca/documents/en/Securities-Category3/20150917-mystery-shopping-for-investment-advice.pdf>.



remuneration practices, would prevent sales practices and behaviours that are all too common today but are contrary to the protection of consumers and fail to place the interests of consumers ahead of the interests of the fund manufacturers and intermediaries who distribute their products.

#### ***Industry Won't Address Problems on their Own***

- 3.15. The financial industry has failed to address the problems associated with conflicted compensation on their own and has failed to increase proficiency adequately or avoid biased compensation models. In fact, quite the opposite is happening. Dealers are creating conflicts of interest given how they incent and compensate their representatives. FAIR Canada believes that the time is long overdue for reform measures by securities regulators and governments so that a statutory best interest standard is implemented with its necessary accompanying rules on avoiding conflicts of interest, including the elimination of embedded commissions.

#### **4. The CSA Proposal – Direct Pay Compensation**

##### ***What Are Embedded Commissions - Definition***

- 4.1. The CSA Consultation paper refers to “the prevailing practice of remunerating dealers and their representatives for mutual fund sales through commissions, including sales and trailing commissions, paid by investment fund managers” as what they mean by embedded commissions.
- 4.2. To the best of our knowledge, there has been no widely used and accepted definition of trailing commissions in Canadian securities law. Trailing commissions are defined in Appendix B to the June 14, 2012 CSA Notice and Request for Comments on Proposed Amendments to National Instrument 31-103 relating to cost and performance reporting requirements, as follows: “trailing commission” means any ongoing payment to a registered firm in respect of a security purchased for a client that is paid out of a management fee or other charge to the investment.”
- 4.3. This definition makes it clear that the trailing commission comes out of the investment and that a third party, the investment fund manager, is providing a commission to the dealer as a result of the sale of the security to the investor.
- 4.4. **We therefore, define “embedded commissions” as used throughout this submission to mean remuneration by a third party (for example an investment fund manager) to dealers (which may or may not also be paid to their representatives) in respect of the sale of an investment (whether it be mutual funds, exchange traded funds, structured products, exempt market products or other types of securities) to an investor.** We note that our definition, like that used by the CSA, does not include any reference to this as being a payment for advice and services that the dealer and its representatives provide to investors. This is misleading as it is a form of compensation for sales.

### **Direct Pay Arrangements**

- 4.5. The CSA would require direct pay arrangements – that is the investor would pay the firm directly for the advice and services provided. Such arrangements could include upfront commissions, flat fees, hourly fees, and fees based on a percentage of assets under administration. In all cases the arrangement would be negotiated and agreed to exclusively by the investor and the dealer through the representative, pursuant to an explicit agreement (we assume to be documented in writing); and the investor would exclusively pay the dealer for the services provided under the agreement.
- 4.6. The CSA explains that it wants to transition to direct pay arrangements that:
- Better align the interests of investment fund managers, dealers and representatives with those of investors (i.e. lessening or avoiding conflicts of interest);
  - Deliver greater clarity on the services provided and their costs; and
  - Empower investors by directly engaging them in the dealer and representative compensation process.<sup>41</sup>
- 4.7. The CSA should also enunciate that it wants to transition to direct pay arrangements in order to foster market efficiency (effective competition that will benefit the investing public) as the current market failure needs to be addressed.
- 4.8. When advice will be a separate and direct cost agreed to by the consumer with the firm, the dealer firm and its representatives will no longer be tied to high fee, actively managed mutual funds. They will be neutral with respect to the various investment products and will be able to consider low cost index funds. Much independent research has found that actively managed funds rarely deliver index beating returns.<sup>42</sup> FAIR Canada believes breaking the tie between selling products (or the “transaction”) and advice is important. Such a step will be important to improving the quality of advice that Canadians receive.
- 4.9. The CSA expects dealers to offer investors a compensation arrangement that suits their particular investment needs and objectives and the level of service desired.<sup>43</sup> For example, the CSA states that ongoing fees should be charged for ongoing services.<sup>44</sup> Therefore, the converse should be

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<sup>41</sup> CSA Consultation Document at 4.

<sup>42</sup> See, for example, the SPIVA Canada Scorecard, available online at <http://us.spindices.com/documents/spiva/spiva-canada-scorecard-year-end-2016.pdf>. See also J.B. Heaton, N.G. Polson and J.H. Witte, “Why indexing works?”, (May 2017), online: <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2673262](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2673262)>. The paper explains why active management dramatically increases the chance of underperformance of the benchmark index. The relative likelihood of underperformance by investors choosing active management is likely much more important than the loss to those same investors from the higher fees for active management relative to passive index investing. Oliver Renick of Bloomberg discusses the research that shows that the reason for the underperformance is largely due to the impact of “skewness”. “...a concentration of outside gains in a minority of index members is tantamount to a death sentence for anyone who gets paid for beating a benchmark”. See Oliver Renick, “Are active managers tilting at a statistical windmill” *Bloomberg* (11 April 2017), online: <<http://www.wealthprofessional.ca/business-news/are-active-managers-tilting-at-a-statistical-windmill-224002.aspx>>.

<sup>43</sup> CSA Consultation Document at 5 and 21.

<sup>44</sup> *Ibid* at 21.

true, if ongoing advice is not provided, then the investor should not incur ongoing advice charges. FAIR Canada concurs as direct pay arrangements will reflect the principle that consumers should not be paying substantial ongoing fees in perpetuity to a financial firm simply as a result of continuing to hold a mutual fund in an account.

- 4.10. ***FAIR Canada recommends that the CSA devise specific principles or rules which will provide for this outcome i.e. so that the dealer doesn't simply offer one direct pay arrangement that benefits the dealer the most.***
- 4.11. ***FAIR Canada recommends that the CSA require the dealers to monitor trading in upfront commission accounts so that churning of the account does not occur to obtain excess payments. FAIR Canada's understanding is that dealers have the ability to do this currently.***
- 4.12. ***FAIR Canada also recommends that the CSA require the types of advice options and the services and types of investments available at a dealer be disclosed in plain language on the main page of the dealer's website so that consumers can easily shop around and comparison shop.***

#### ***Types of Investments Subject to a Ban on Embedded Commissions***

- 4.13. The CSA proposes that the ban on embedded commissions would apply to an "investment fund" (conventional mutual funds, ETFs and non-redeemable investment funds) and structured notes, whether sold under a prospectus or in the exempt market under a prospectus exemption. FAIR Canada supports having a broad based ban. ***Indeed, FAIR Canada recommends that the ban on embedded commissions go further and apply to any "security".***

#### ***Addressing Regulatory Arbitrage***

- 4.14. FAIR Canada is well aware that given our product silo approach to regulation, some products that financial consumers would consider "investments" are not regulated as securities. ***FAIR Canada continues to recommend that the risk of regulatory arbitrage with segregated funds, principal protected notes, index linked GICs or other investment products should be addressed by: (i) determining that advice not to invest in a security (in favour of a non-security) is advice about securities and is subject to a best interest standard; (ii) amend the definition of "securities" so that segregated funds are no longer exempted from provincial securities acts; and (iii) preclude acceptance of third party commissions in respect of investment products regardless of whether a security or not.***<sup>45</sup> We also support the measure noted in the Consultation Document aimed at having insurance regulators harmonize their regulatory frameworks so that mutual funds, segregated funds and other investment products are subject to the same rules including a requirement to remove embedded commissions.
- 4.15. A recent report by the MFDA<sup>46</sup> highlights that its non-deposit taker and non-direct sales dealer members have a sales force that are almost all dually-licensed to sell insurance. The report also

<sup>45</sup> See FAIR Canada submission to the CSA regarding CSA Discussion Paper and Request for Comment 81-407 Mutual Fund Fees (12 April 2013), online: <<http://faircanada.ca/wp-content/uploads/2013/04/FAIR-Canada-comments-re-Mutual-Fund-Fees.pdf>>.

<sup>46</sup> MFDA Bulletin #0721-C, MFDA Client Research Report (23 May 2017).

notes that 53% of these representatives (or 19,021 individual representatives aka “advisors”) likely do not have a book of business large enough to currently support themselves on mutual fund sales alone and moreover, they likely finance their operations through DSC commissions. This MFDA Report confirms what we fear – that many investors in the MFDA channel are getting commission driven sales recommendations that are harmful, through embedded commissions, DSC arrangements and insurance product recommendations that are high fee and would not meet a suitability standard in most cases, let alone be in the best interest of the consumer.

- 4.16. The MFDA Report in FAIR Canada’s view, highlights the need for reform of the mutual fund fee structure to remove embedded commissions including DSCs, and highlights for governments that harmonization of regulatory frameworks needs to occur so that like consumers receive advice in their best interest rather than product-driven sales recommendations. This should be the case regardless of the type of investment (banking product, insurance product, securities product).

#### ***Facilitation of the Investor’s Payment of Dealer Compensation***

- 4.17. Direct pay arrangements are beneficial as no longer will the investment fund manager determine the compensation paid to the dealer with no direct involvement of the client. This will break the perverse form of competition that exists whereby investment fund managers compete by offering to pay higher trailing commissions to dealers rather than on performance of their funds and their skill. FAIR Canada agrees with the analysis provided in Appendix A on how embedded commissions reduces investors’ awareness and understanding and control of dealer compensation (so called “advice”) costs.
- 4.18. FAIR Canada believes that direct payment for advice is essential to real price competition in the investment fund industry. Consumers should agree to the fees in advance and such fees should be freed from the product. We believe this is an essential step to foster healthier competition.
- 4.19. While the CSA proposal requires direct pay arrangements and would prohibit payments by third parties to dealers out of fund assets or revenue, the proposal does permit allowing investment fund managers and structured note issuers to “...facilitate the investor’s payment of dealer compensation. Specifically, the investment fund manager would be permitted to collect the dealer’s compensation, either through deductions from purchase amounts or through periodic withdrawals or redemptions from the investor’s account, and remit it to the dealer on the investor’s behalf, provided the investor consents to this method of payment.”<sup>47</sup>
- 4.20. Various studies suggest that the further removed a transaction is from cash, the less price-sensitive consumers are about the costs. **FAIR Canada disagrees that payment for advice be should be permitted to be automatically deducted from the consumer’s account by the investment fund manager. We believe that this arrangement could encourage the dealer and its representatives to continue their relationships with certain investment fund managers when this may not be in the best interest of the client.** The dealer and its representative may continue to offer certain mutual funds as a result, rather than recommend lower cost ETFs for example. The separation of the relationship between advice and product recommendations may

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<sup>47</sup> Consultation Document at 22.

be impeded by such continued relationships. Adoption of this type of system may create problems of a similar nature to the one it is trying to solve.

- 4.21. FAIR Canada recommends that the CSA determine other alternative forms of payment such as keeping a portion of the client's funds in a high interest savings account or money market funds to pay for ongoing advice received. This would ease the "pain" associated with writing a cheque while not creating relationships that lead to conflicts that harm consumers.

#### ***Allowing Other Types of Dealer Compensation Payments***

- 4.22. The Consultation Document states that the CSA jurisdictions would continue to permit the following types of dealer compensation payments:

- Referral fees paid for the referral of a client to or from a registrant in accordance with NI 31-103;
- Dealer commissions paid out of underwriting commissions on the distribution of securities of an investment fund or structured note that is not in continuous distribution under an initial public offering;
- Payments of money or the provision of non-monetary benefits by investment fund managers to dealers and representatives in connection with marketing and educational practices under Part 5 of NI 81-105; and
- Internal transfer payments from affiliates to dealers within integrated financial service providers which are not directly tied to an investor's purchase or continued ownership of an investment fund security or structured note.<sup>48</sup>

- 4.23. The CSA states that "at this time" it would permit the above-noted forms of dealer compensation payments even though it admits that they "...may give rise to conflicts of interest that may continue to incent registrant behavior that does not favour investor interests", but does ask whether they should consider discontinuing such payments.<sup>49</sup>

- 4.24. ***FAIR Canada recommends that the CSA not permit conflicted dealer compensation payments that lead to incentives and behaviours that subvert the interests of consumers, and that all compensation (referral fees, underwriting commissions and other sales incentives) should be examined.***

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<sup>48</sup> Ibid.

<sup>49</sup> CSA Staff Notice 33-318, *Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives* (2016), 39 OSCB 10115 at 10116, online: <[http://www.osc.gov.on.ca/documents/en/Securities-Category3/csa\\_20161215\\_33-318\\_incentives.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category3/csa_20161215_33-318_incentives.pdf)>.

## Referral Fees

4.25. **FAIR Canada continues to believe, as recommended in its submission on CSA Consultation 33-404 (Proposed Best Interest Standard and Proposed Targeted Reforms), that disclosure of referral fees for selling certain products is not adequate and such conflicted payments should be prohibited.**<sup>50</sup> We also recommended that the rules around referral fees be updated. ***FAIR Canada is of the view that a best interest standard is needed so that any referral arrangement only occur in the context of a client's best interest, and therefore when there is an absence of any conflict of interest as a result. In addition, there should be full transparency, and the fact of the fee, its amount and its impact should be disclosed in plain language before or at the time the payment is made.***

4.26. Referral fees are leading to behaviour that is detrimental to clients. The following types of referral arrangements have been highlighted by securities regulators:

- (i) *Referrals to facilitate loans used to purchase mutual funds - "Recommendations that clients borrow to invest in funds on a DSC basis enable the dealer and their representative to increase the total compensation they can earn from the investment. Specifically, they may receive a referral fee from the financial institution in connection with their client's loan in addition to the 5% upfront commission (plus the ongoing trailing commission) they may receive from the investment fund manager on the purchase transaction."*<sup>51</sup>
- (ii) *Referrals to sell additional products or services to clients not based on need or suitability - "Some firms use one-time or ongoing payments as an incentive for representatives to pass on business to related and/or third party financial service providers. Practices among surveyed firms ranged widely and included receiving one-time and ongoing (in some cases perpetual) referral fees and receiving both securities and non-securities related referral fees, including referral fees on mortgages, investment loans and insurance.*

This practice may encourage representatives to search through their existing books of business to find those clients that could be sold the targeted product or service whether they need it or not. In the case of related party referral arrangements, it may encourage representatives to send their clients to another arm of their firm, even when third party product and/or service options may be more suitable. It may also encourage representatives to shift clients to more profitable business lines within the firm with little or no benefit to the client."<sup>52</sup>

- (iii) *Referrals between MFDA dealers and portfolio managers – This can be comparable to a mutual fund trailing commission. Firms have the ability of firms to structure arrangements as referral arrangements rather than distribution agreements, in order to avoid regulatory requirements including National Instrument 81-105.*<sup>53</sup>

<sup>50</sup> MFDA Bulletin #0705-C, *supra* note 17.

<sup>51</sup> CSA Consultation Document at page 104.

<sup>52</sup> CSA Staff Notice 33-318, *supra* note 30.

<sup>53</sup> MFDA Bulletin #0705-C, *supra* note 17.

- 4.27. FAIR Canada believes that securities regulators must prevent payments that are detrimental to consumer's interests and, if they do not, they will become even more pervasive. Firms should not be able to do indirectly what they are not able to do directly.
- 4.28. ***FAIR Canada believes that referral fees for facilitating loans so that clients borrow to invest in mutual funds should be prohibited immediately as this leads to unsuitable recommendations to borrow to invest, often with disastrous consequences for the consumer.***
- 4.29. FAIR Canada also believes that consumers are not receiving adequate disclosure of referral arrangements in accordance with existing regulatory requirements.<sup>54</sup> And, even if they were, they would not appreciate the bias created by the conflicts and what that means for the advice and services to be provided.
- 4.30. ***Internal Transfer Payments between Affiliated Dealers*** – There are internal transfer payments from affiliates to dealers within integrated financial services providers, which may be directly tied to an investor's purchase or continued ownership of an investment fund security or structured note. Presumably such transfers are used to pay for bonuses and sales targets and other forms of compensation that skew the advice provided towards the firm's own product. There are also internal transfer payments that are not directly tied. The nature and form of these payments, and their relationship to the embedded commissions that are collected/received by these financial firms need to be better understood. The regulators need to better understand these payments and convey that information to the public. ***FAIR Canada recommends that internal transfer payments not be allowed to circumvent the prohibition of embedded commissions through another means.***
- 4.31. FAIR Canada notes that the U.K.'s RDR reforms introduced requirements on vertically integrated firms who sold their own products. They were required to ensure that the charges for their advice service covered the costs of providing that service and that the firm did not unreasonably cross-subsidize these costs from other areas of their "value chain", such as their products. The rules were intended to prevent these firms from subsidising the costs of advice through their product charges and thus offering advice as a "loss-leader" in order to sell investors their own products.<sup>55</sup> This rule was amended to address the development of new business models while still ensuring that over the long-term the charges for their advice services cover the costs of providing that service.<sup>56</sup> ***FAIR Canada recommends that a cross-subsidization rule be examined in order to ensure a competitive landscape and not provide an undue advantage to vertically integrated firms.***

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<sup>54</sup> A quick look at some referral disclosures available online highlights the benefit to the consumer of these arrangements ("The purpose of these referrals is to introduce you to experts within the [unnamed] bank group who are best suited to help you achieve your financial goals"). The only mention of conflicts of interest is that the bank has "policies and procedures" to assist in "identifying and addressing any conflicts of interest that may arise" and the consumer is directed yet to another brochure full of legalese. FAIR Canada believes that there is likely widespread non-disclosure to consumers of the specific conflict of interest that occurs when a representative refers a consumer to another affiliated entity or third-party.

<sup>55</sup> Financial Conduct Authority, Final Report on the *Financial Advice Market Review* (March 2016), online: <<https://www.fca.org.uk/publication/corporate/famr-final-report.pdf>> at 37 [FCA Final Report].

<sup>56</sup> Financial Conduct Authority, *Financial Advice Market Review Progress Report* (April 2017), online: <<https://www.fca.org.uk/publication/corporate/famr-progress-report.pdf>> [FCA Progress Report].

- 4.32. ***Integrated Financial Services Firms and Proprietary Products*** - Professor Cumming's report found that affiliated dealer flows showed no flow-performance sensitivity at all. This was found to be relatively more detrimental to investors relative to all trailing commission paying purchase options for non-affiliated dealer flows. He explained that affiliated dealer flows also results in material conflicts of interest that are detrimental to mutual fund investors over the long term.<sup>57</sup>
- 4.33. ***Therefore, FAIR Canada continues to recommend that a clear picture be provided to consumers. Firms that only sell affiliated dealers products should not be able to hold out that they provide advice in the best interests of consumers and their representatives should be restricted to the title "salesperson".***
- 4.34. ***FAIR Canada further recommends that if bank branches or affiliated dealers of insurers want to provide advice in the best interests of consumers they should be required to have an open shelf and this should be monitored on a comprehensive basis so that sales incentives, compensation grids, performance targets or reviews or internal transfer payments don't favour the sale of proprietary products over others, to the detriment of clients. There should be annual disclosure of the extent to which proprietary versus third party products are sold.***
- 4.35. ***Payments of money or the provision of non-monetary benefits by investment funds managers to dealers and representatives in connection with marketing and educational practices under Part 5 of NI 81-105 – FAIR Canada recommends that these payments should be prohibited as they are riddled with conflicts of interest and do not serve consumers' interests.***
- 4.36. In light of the removal of embedded commissions and avoidance of conflicts of interest, ***FAIR Canada also recommends that National Instrument 81-105 Mutual Fund Sales Practices be completely reworked.*** We also note that to date, there has only been one enforcement action resulting from this rule. The Sentry case<sup>58</sup> demonstrates how entitled the financial services industry can become at the expense of its clients.

## **5. FAIR Canada's Comments on the Predicted Consequences of Banning Embedded Commissions**

### ***Benefits of banning embedded commissions***

- 5.1. FAIR Canada believes that a ban on embedded commissions should be undertaken with a ban on other forms of conflicted compensation structures that have been identified. Incentives that distort advice and subvert the interests of consumers should be addressed at the same time. The benefits that will flow from banning embedded commissions include:
- (i) Reduction in fund series and in fund fee complexity - the fund fee structure will be simplified and made more transparent;
  - (ii) Increased price competition and decrease in fund management costs;

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<sup>57</sup> Professor Cumming Q&A, *supra* note 8 at 7.

<sup>58</sup> *OSC Staff Statement of Allegations re Sentry Investments Inc.* (31 March 2017), online: <[http://www.osc.gov.on.ca/documents/en/Proceedings-SET/set\\_20170331\\_sentry.pdf](http://www.osc.gov.on.ca/documents/en/Proceedings-SET/set_20170331_sentry.pdf)>.



- (iii) New lower-cost product providers may enter the market (reduce barriers to market entry and increase price competition);
- (iv) Shift in product recommendations to lower-cost and passively managed products including exchange traded funds;
- (v) The market will innovate including through offering different forms of direct payment arrangements and through the use of fintech and online advice (robo advice) so that various consumer segments are served (including those with less assets);
- (vi) Increase in transparency to the consumer as to what they pay as product costs (management fees and operating expenses of the fund) as opposed to what they pay for “advice” and services of the dealer/representative, which will better allow consumers to assess value and control such costs;
- (vii) Advisors and their firms will no longer be incented by higher trailing commissions and fund managers will have to compete based on performance rather than on the basis of paying higher trailing commissions;
- (viii) Ability to comparison shop – greater transparency should allow consumers to know, before they speak with a firm/representative and certainly before they enter into a relationship, what the cost will be for advice and services (and what those services and advice include (and do not include)) so as to compare the costs and services/advice of different firms (and their representatives);
- (ix) Consumers will be able to assess the value of any services and advice they pay against the costs they incur, on an ongoing basis rather than simply reviewing the amount of trailing commissions and other costs they currently incur annually, as a result of the required cost reporting and performance reporting documents (CRM2 Statements);
- (x) Quality of the advice provided should improve and given product bias should be reduced. Business models should be capable of focusing on advice such as creating and following a budget, prioritizing short and longer term goals, paying down debt, and saving in the most tax efficient manner in light of income etc., rather than simply focusing on product sales;
- (xi) Enhance the professionalism of the financial services industry and enhance public trust in the industry and financial markets which would benefit both investors, dealers and representatives.

5.2. The Consultation Document makes an assessment of the possible market impacts of discontinuing embedded commissions, which appear reasonable based on the assumptions it has made.<sup>59</sup> FAIR Canada has made recommendations above to improve the impacts of

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<sup>59</sup> The Consultation Document’s listed benefits include: (i) reduction in fund series and fund fee complexity; (ii) new lower-cost product providers may enter the market; (iii) increased price competition/decrease in fund management costs; (iv) shift in product recommendations to lower-cost/passively managed products; (v) shift in assets across existing investment fund managers; (vi) market innovations in product distribution and advice.

The consequences to investors by segment are described as follows:

discontinuing embedded commissions and by addressing other inherent conflicts that have been identified. We have also made recommendations with respect to integrated financial services firms so that critical dealer affiliation issues are addressed and it is made clear to consumers whether they are getting advice in their best interest (open product shelf) or sales advice (proprietary products only) when they go to an integrated financial services dealer. This, accompanied by the ban on embedded commissions, should help foster a competitive landscape. Our recommendations in this submission are consistent with our recommendations on best interest. The two proposals go hand in hand.

### ***The Existing Advice Gap***

- 5.3. FAIR Canada disagrees with the industry's weak argument that if the CSA implements a ban on embedded commissions, then some investors, especially those with smaller amounts, will be unable to obtain "access to advice". The argument is that these investors will not be able to afford advice. This argument is wrong for a number of reasons.
- 5.4. It should be made clear that "advice gap" is defined in the Consultation Document to mean a group of investors who cannot obtain the amount of advice they desire at the price they are willing to pay.<sup>60</sup> Firstly, such a gap exists for many different types of services – accounting services, tax services or pension advisory services. A gap will always exist to some extent for financial or investment advice. Only 37% of Canadians own investment funds and amongst those who do, only 58.5% of them use an advisor. For those who have investable assets up to \$100,000,

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"Mass-Market Investors (investable assets below \$100,000) – lower product costs and better performing products, eliminate incentive to engage in unsuitable leverage strategies; use of online/discount brokerage without having to pay a trailing commission; some independent fund dealers may choose not to continue to service these individuals. No significant change in fund products recommended at integrated firms although cost and performance may change due to new market entrants. Risk of reverse churning. Risk of churning if the account is transaction-based commissions (but no trailing commission). Advice – No anticipated significant advice gap. It is possible that the cost of traditional advice may rise for this group – direct pay arrangements and other regulatory reforms may increase the cost of dealers' operations and compliance, which may lead to an increase in the cost of advice. Some investors may be pushed into online advice relationships, others more simplified forms of advice, or the online/discount brokerage channel, even through these services may not meet all their needs and even though they may prefer, but can no longer afford, face-to-face advice". It suggests some may be discouraged from seeking financial advice as they may not want to pay fees for "advice" when they are not receiving any outside of the required suitability assessment.

Mid-Market Investors (investable assets between \$100,000 and \$500,000) – lower product costs, more use of passively managed funds, improved investor outcomes. Could be switched into fee-based accounts when transaction-based fees may be better for their circumstances (shift already happening today). Possibility of reverse churning. They state that the CSA 33-404 proposals would limit this.

Advice - different types of services and advice options offered with resulting greater control and clarity over the advisor/client relationship, possibly offered discretionary advice over time.

Affluent Investors (investable assets above \$500,000) – Least impacted because less use of embedded commissions. Reduced product costs and more use of passively managed funds. Usage of discretionary advice likely to increase substantially. Will be provided the most flexibility in terms of payment arrangements and the most number and scope of advice delivery and service offerings.

Do it yourself investors – Will lower costs as they would no longer pay the full trailing commission and should benefit from decline in fund management costs. It expects that DIY investors will be charged transaction-based or asset-based fees "to offset the revenue lost from trailing commissions at roughly but only at a quarter of what they pay today. See Consultation Document at 51 to 72.

<sup>60</sup> Consultation Document at 62.

only 45% currently use an advisor.<sup>61</sup>

- 5.5. Secondly, it is wrong because investors, especially those with smaller amounts to invest (in the Consultation Document referred to as mass-market investors), are already paying for advice. If you believe the industry's argument that trailing commissions pay for "services and advice" rather than commission payments to incent the sale of products, then investors can and already do "afford" to pay for advice. A ban on embedded commissions would simply put those dollars under the control of the consumer so that they could decide for themselves how much and what kind of advice they want, and how much they are willing to pay for it.
- 5.6. Thirdly, there is no legal obligation to provide advice to consumers beyond meeting suitability obligations at the time of the transaction and in accordance with certain triggering events under CRM obligations. Accordingly, many of those with smaller amounts to invest often get no "advice" beyond the sales product recommendation (or a phone call at RRSP deadline season). At discount brokerages, the dealer is not permitted to provide any recommendation or advice. Canadians have been paying dearly in embedded commissions despite not receiving advice or product recommendations of any kind.
- 5.7. Fourthly, Canadians who have bought mutual funds with embedded commissions are not getting objective advice, but instead product sales under the guise of advice and these funds underperform. Canadians need objective professional advice to help them pay down debt and accumulate savings, but all too many Canadian are not getting this.
- 5.8. Fifthly, there is no independent study that shows that Canadians will not pay directly for advice. Canadians will be able to understand more clearly what they pay for "advice" versus what they pay for the product, and will be able to assess value. The answer is not to charge Canadians and hide the costs and harms those commissions engender.
- 5.9. The financial service industry has an ability to innovate and develop new ways to serve those Canadians who have smaller amounts to invest. Robo-advice has already entered the Canadian market and further innovation will occur to provide cost effective advice that meets the needs of Canadians.

### *The UK Example*

- 5.10. In the U.K., not only were embedded commissions banned, but the Retail Distribution Review ("RDR") also increased proficiency requirements for representatives. In addition, in 2015, pension reforms were introduced so that consumers had access to their defined contribution pensions at age 55. The 2015 pension reforms thus created a situation where a large number of consumers were to make a significant financial decision at a time of unprecedented control over their pensions. This increased the public policy need to ensure that consumers had access to advice – and could obtain the amount of advice they needed at a price they were willing to pay.
- 5.11. The U.K. embarked on a Financial Advice Market Review of their reforms. This Review was undertaken to ensure that affordable advice and guidance is available to everyone at an amount

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<sup>61</sup> Ibid at 28-29.

each is willing to pay. The Consultation Document notes that the amounts currently paid for advice under fee-based accounts, are as follows: initial charges of 1% (minimum) to 3% (maximum) and ongoing charges of 0.5% (minimum) to 1% (maximum).<sup>62</sup> With the introduction of robo-advice, advice costs will face more competitive pressure.<sup>63</sup>

- 5.12. The Review noted that RDR brought about positive changes as it reduced product bias on recommendations and increased the sale of low cost products. It also increased professionalism and transparency. There was some drop in the number of advisors when the reforms came into place as older advisors chose to retire rather than meet the new proficiency requirements. This problem appears to have been overstated as it has been reported that there are now more advisors in the UK than there were pre-RDR Reforms.<sup>64</sup> The number of registrants is not foreseen to be a problem in Canada. In the UK pre-Retail Distribution Review, there was one advisor for every 1,553 whereas there is one representative for every 336 Canadians as of 2015.<sup>65</sup>
- 5.13. The UK has made significant strides forward resulting from its reforms and there is no appetite to returning to an embedded commission structure: "Given the strong arguments against a commission-based system, such as the lack of transparency and distortion of incentives, FAMR does not believe there is a case to consider this, and is therefore not recommending a return to commission-based financial advice."<sup>66</sup>

## 6. Transition Date

- 6.1. FAIR Canada believes that a Transition Date of two years (rather than three) is more than sufficient for all affected parties to ensure a successful transition and to complete all necessary transition steps. We favour a defined transition period as this would provide more clarity for consumers who wish to explore alternatives and is a more simple approach for all participants.
- 6.2. FAIR Canada does not support a move to fee cap as a transition measure. This would likely delay the effective transition date and would add unnecessary complexity while not addressing the harms caused by embedded commissions.
- 6.3. FAIR Canada wishes to express some frustration at the slow pace at which investor focussed initiatives proceed. These delays result in investors continuing to be inadequately protected, subject to a marketplace that is inefficient and results in unnecessary with significant costs being incurred by Canadians. In light of some industry stakeholders' arguments, the CSA has taken the time to obtain direct empirical evidence based on Canadian data that the conflicts impact investor outcomes negatively. However, that research was released in October 2015.
- 6.4. Careful consideration and assessment of the impacts on all stakeholders (most importantly the investing public i.e. ordinary Canadians) and consultation is important. **However, timely**

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<sup>62</sup> Ibid at 149.

<sup>63</sup> <https://www.fca.org.uk/publication/corporate/famr-progress-report.pdf> FCA Progress Report, *supra* note 60.

<sup>64</sup> Susan Yellin, "What Canada can learn from the Australian and U.K. Experience" (20 January 2014), *The Insurance & Investment Journal*, online: <<http://insurance-journal.ca/article/banning-embedded-commissions-a-series-of-three-articles-by-susan-yellin/>>.

<sup>65</sup> CSA Consultation Document at 38.

<sup>66</sup> <https://www.fca.org.uk/publication/corporate/famr-final-report.pdf> FCA Final Report, *supra* note 59 at 46.

**response to market failures and investor harm is also important so that those harms can be redressed. Delays only benefit the industry.**

## **7. Conclusion**

- 7.1. FAIR Canada is strongly of the view that a statutory best interest standard is urgently needed. One of the keys to a best interest standard is avoiding conflicted compensation structures, including embedded commissions. FAIR Canada supports the elimination of embedded commissions and strongly urges the CSA to move forward with this step and at the same time to address the other conflicted compensation structures and practices that subvert the interests of investors.
- 7.2. FAIR Canada has made recommendations in this submission to improve the CSA's reform proposal so as to improve the ability of Canadians to receive advice that it is in their interests, and to encourage effective competition for the benefit of the investing public. The ban on conflicted compensation will foster fair and efficient markets and investor protection.
- 7.3. We urge the CSA to move forward with this expeditiously. FAIR Canada also urges all CSA jurisdictions to adopt a statutory best interest standard as set out in our submission on CSA 33-404 along with the accompanying reforms we believe are needed (increasing proficiency and restricting the use of titles).<sup>67</sup> For those jurisdictions that have indicated they will move forward with a best interest standard, they should move forward quickly to prohibit embedded commissions - a best interest standard should include a prohibition against the acceptance of embedded commissions and other conflicted compensation.

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 Marian Passmore at 416-214-3441/[marian.passmore@faircanada.ca](mailto:marian.passmore@faircanada.ca).

Sincerely,



Canadian Foundation for Advancement of Investor Rights

Cc 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, New Brunswick

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<sup>67</sup> See FAIR Submission on 33-404, *supra* note 11.

Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland and Labrador  
Superintendent of Securities, Northwest Territories  
Superintendent of Securities, Yukon  
Superintendent of Securities, Nunavut