FAIR

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

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RE: MFDA Discussion Paper on Expanding Cost Reporting

FAIR Canada is pleased to offer comments on MFDA Bulletin #0748-P, Discussion Paper on Expanding Cost Reporting (the "Discussion Paper").

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

1. Executive Summary

1.1. FAIR Canada welcomes the MFDA's Discussion Paper's attempt to improve cost reporting requirements and the level of client understanding of their total costs of investing. FAIR Canada supports disclosure that lets investors know prospectively what the costs will be, what costs they have actually incurred (regardless of the type of investment or registrant) and the cumulative impact of the actual costs on investment returns.

1.2. FAIR Canada believes investors would be best served by eliminating conflict of interests rather than by more fulsome disclosure of the costs of conflicted compensation. The absence of conflicts of interest should be the goal.

1.3. Any expansion of disclosure must ensure that (i) the expanded disclosure is tested by an appropriately qualified independent third party with investors (and this testing is made public) to ensure it is meaningful, comprehensible and in their best interest.

1.4. Investors should know, in advance, of the costs of investment advice and services they will be directly or indirectly paying or charged along with the cost of the investment products, and how they will be paying for these costs and fees. Also necessary is making sure investors know what kind of advice and services they will receive – conflicted advice limited to one type of investment product (mutual funds) or independent, objective advice in the best interest of the client which selects from a wide range of potential suitable investment products.

1.5. With the CSA Client-Registrant Reforms inclusion of cost as an element of suitability, it will be

important for there to be disclosure of total costs prior to a client engaging with a firm and prior to a firm recommending an investment product.

1.6. We urge the CSA, MFDA and IIROC to benchmark to leading jurisdictions, and to test proposed disclosure with investors so that disclosure is in the best interests of investors. "How" costs are disclosed should be given as much consideration as "what" costs are disclosed. Quality, simplicity and comprehensibility need to be key considerations as well as likely impact on investor decision-making and behaviours.

1.7. We believe that consideration of expanded cost disclosure is in its formative stages as regulators need to reflect on the policy goals of expanding cost disclosure, the optimal means of achieving these goals and consider factors such as what the impacts will be of the CSA's Reforms to Enhance the Client-Registrant Relationship as well as the CSA's Mutual Fund Fee Reforms. The focus should be on the best interests of investors, and improving investor protection and investor outcomes.

2. Introduction

2.1. FAIR Canada welcomes the MFDA's Discussion Paper's attempt to improve cost reporting requirements and the level of client understanding of their total costs of investing.

2.2. The Discussion Paper considers costs in the area of ongoing costs of owning investment funds, transactional costs charged by investment funds (such as redemption fees and short term trading fees), costs paid by clients directly to third parties for account administration (such as custodial or intermediary fees taken directly from a client's account but not charged by or paid to the registered firm) and costs related to other investment products (with the MFDA not proposing to expand cost reporting for non-investment fund products given the lack of automated data).

2.3. FAIR Canada supports disclosure that lets investors know prospectively what the costs will be, what costs they have actually incurred (regardless of the type of investment or registrant) and what impact the actual costs incurred have on their investment returns.

3. FAIR Canada's General Comments on Disclosure of Conflicted Compensation

3.1. FAIR Canada believes investors would be best served by eliminating conflict of interests rather than by more fulsome disclosure of the costs of conflicted compensation. The absence of conflicts of interest should be the goal. Managing or controlling for such conflicts, mainly through disclosure, will not work and will not protect investors from the harms these practices cause.

3.2. Compensation structures containing monetary and non-monetary inducements conflict with the interests of clients. When advisors, dealers, financial service firms or their representatives ("financial service providers") receive an incentive for selling certain products to clients, or bonuses for meeting certain sales targets, a misalignment between the interests of dealers and registrants occurs vis a vis their clients, and the objectivity of advisors is undermined. FAIR Canada is firmly of the view that these conflicts of interest are pervasive and cause harm to the market and investors, and that simply disclosing the existence of a conflict and/or its cost does not fix the problems.

3.3. We urge the MFDA and CSA to review the extensive research which shows that disclosing conflicts of interest is not an effective way to protect investors: investors do not understand conflicts of interest or how to appropriately factor the impact of a conflict of interest into their evaluation of investment recommendations; disclosing conflicts of interests has been found to have unintended effects that often make matters worse for the investor; disclosing conflicts of interests may lead advisors to unconsciously provide biased advice; and allowing conflicts of interest to continue can create systemic and structural problems (preventing effective competition) that harms the market as well as investors[1].

3.4. Regulators and governments need to ensure that financial service providers who are relied upon to help further consumers' interests (for example, to help them to adequately save for retirement or save for their children's education) have the ability to provide objective, unbiased professional advice. This requires ensuring that financial service providers are not permitted to receive conflicted forms of remuneration. Only incentives and fee structures that are aligned with consumers' interests should be permitted.

3.5. The harm caused by conflicts of interest must be addressed head on if we are to achieve a situation where clients are better off as a result of engaging with the financial services sector. The bottom line is that, in light of significant conflicts of interest, disclosure as the "go-to" solution does not work and hurts the financial outcomes of those it is intended to protect.[2]

3.6. FAIR Canada is strongly of the view, in light of the evidence, that disclosure is insufficient to address the problems caused by conflicts of interest in the financial sector. The best solution is to eliminate conflicts of interest to the greatest extent possible.[3]

3.7. While disclosure may make regulators and even those who are regulated feel like they have taken action to remedy the situation, the reality is far from it. We cannot ignore the fundamental problems created by conflicted remuneration. Rather, as has been recognized in many other jurisdictions (Australia, the United Kingdom, Europe), the solution is to address conflicted remuneration. This is a necessary step in moving to a framework where financial advice can be provided in the client's best interest. It is simply illogical to expect advice to be provided in the client's best interests when the financial service provider is part of a business model where he/she is being asked to serve two masters.

3.8. Failure to address these fundamental conflicts that have been identified and empirically shown to exist in Canadian capital markets[4] would be a failure to fulfill the mandate of provincial securities

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

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

3 Behavioural science research supports the conclusion that disclosure is beneficial where an absence of conflicts of interest is what's being disclosed; but the research does not indicate that disclosure is otherwise beneficial. See: Sunita Sah and George Loewenstein, "Nothing to Declare: Mandatory and Voluntary Disclosure Leads Advisors to Avoid Conflicts of Interest", (2013) Psychological Science, 575; online: https://www.cmu.edu/dietrich/sds/docs/loewenstein/NothingDelcare.pdf.

4 As noted by Professor Cumming, Sofia Johan and Yelin Zhang, "A Dissection of Mutual Fund Fees, Flows, and Performance". Previous research has been completed in this area by many others. See Frequently Asked Questions about the Dissection of Mutual Fund Fees, Flows and Performance, page 4 and footnote 1, online at: http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20160209_81-407_faq-dissection-mutual-fund-fees.pdf;

commissions: that of providing protection to investors and fostering fair and efficient capital markets and confidence in capital markets.

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

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

4. Disclosure of Costs Before Investing

4.1. Investors should know, in advance, of the costs of investment advice and services they will be directly or indirectly paying or charged along with the cost of the investment products, and how they will be paying for these costs and fees (advice and service fees - hourly fee or annual set fee, fee based on assets under management, or through trailing commissions (third party payments) plus how investment product costs work – bid/ask spread, management fees taken from gross returns) before making any commitment so that they can make an informed decision. Consideration will need to be given to the different points at which an investment product can be distributed to a retail investor so that there are not cost gaps.

4.2. Also necessary is making sure investors know what kind of advice and services they will receive. Will investors obtain independent, objective advice in the best interest of the client while being able to select from a wide range of potentially suitable investment products or will investors receive only "suitable" recommendations based on primarily one type of product – mutual funds – for which the firm and its representatives are in a conflict of interest given the compensation structure. In short, is it the provision of professional, financial advice in the client's best interest or primarily a sales relationship. This should be disclosed up front. Please see section 2 above for our position on compensation related conflicts.

4.3. With the CSA Client-Registrant Reforms inclusion of cost as an element of suitability, it will be important for there to be disclosure of total costs prior to a client engaging with a firm and prior to a firm recommending an investment product.

5. Cost Disclosure Requirements Should Be the Same and Go Beyond Investment Funds

5.1. Cost reporting requirements should be the same regardless of the type of product or firm – increasing the transparency and comparability of costs and charges/fees is important in order to help investors pay sufficient attention to costs so that they understand their relevance and in order

See also The Brondesbury Group, *Mutual Fund Fee Research*, (2015) (prepared for the Ontario Securities Commission on behalf of the Canadian Securities Administrators) at 13 to 18, online: http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20150611_81-407_mutual-fund-fee-research.pdf.

to encourage more effective price competition.

5.2. Costs disclosure requirements for integrated firms should be no different than firms that sell unrelated third-party investment fund manufacturers' products which should be no different from disclosure for exempt market products (as many MFDA dealers are also exempt market dealers), or individual securities, for example.

5.3. Any future changes to disclosure, if deemed to be in the best interests of investors, should be required of all registrants in all regulated investment-related activities so that investors can meaningfully compare the reports they may receive from various firms, regardless of which regulator oversees them.

6. Annual Cost Disclosure Requirements (After Investing)

6.1. Investors should be provided with annual disclosure which provides them with the monetary costs they have actually incurred (each item totalled separately plus an all-inclusive aggregated amount) for (a) investment advice and services, (b) third party payments and/or trailing commissions and deferred sales commissions (until/unless prohibited) and (c) investment product costs.[5]

6.2. Detailed break down of these costs may be desired by (i) all investors or only (ii) some segment of investors and surveys, testing and consultation with investors will be necessary to determine the level of detail that is optimal. For electronic disclosure, click throughs could expand the level of detail for those who wish to see it.

6.3. The transparency and simplicity of how the information is disclosed needs to be considered and weighed along with providing disclosure of all items that make up the costs. The BCSC's study of the impact of CRM2 on investors has demonstrated that some investors do not review their statements and the AMF's focus groups made it clear that many investors have trouble understanding their investment statements and their annual cost and compensation disclosure statements. Information quality needs to be assessed. Current CRM2 disclosure should be assessed as part of the review and attempt to improve what is disclosed. What are the main formats being utilized by dealers for the cost and compensation reports and performance reports? "How" it is disclosed, is also critical.

6.4. Investors should be provided with information about the cumulative effect of the costs on their returns – few investors understand the impact of the annual costs on their total investment returns despite how costs can have a substantial impact on a person's ability to accumulate adequate savings for their retirement or other financial goals. This is a requirement under the EU's MiFid II Directive 2014/65/Eu, section 2, Article 24.

6.5. Costs should be shown in dollars and as a percentage. Trailing commissions and deferred sales charges paid (albeit indirectly through the MER) by investors and other third party payments should be shown separately irrespective of whether the firm is an "integrated firm or "integrated member" that "…do not earn compensation directly from sales activity but rather earn compensation through internal transfer payments". The disclosure should be required if the

[5] It will be important to ensure that costs are not double-counted – for example, trailing commission costs should be in the third party payments/trailing commission line rather than in the Product Cost bucket.

investor is charged a trailing commission. The investor is provided with fund fact disclosure which indicates a trailing commission, and it is in the best interest of investors that they know how much in trailing commissions they are paying (that is assuming such payments are not banned – a ban would be far preferable and better serve retail investors).

6.6. Any expansion of disclosure must ensure that (i) the expanded disclosure is tested by an appropriately qualified independent third party with investors (and this testing is made public) to ensure it is meaningful, comprehensible and in their best interest.

6.7. Behavioural economics findings make clear that how such information is presented to investors has a great impact on how the information is understood and used. Therefore, any proposed cost disclosure amendments will need to be tested including actual field tests. The salience and comprehension of the information may be impacted by how the information is displayed or formatted and testing should be undertaken. The CSA did not mandate how CRM2 cost and compensation disclosure information was to be presented or formatted but these factors alone can have a significant impact on investor perceptions, comprehension and their willingness to act on the information. Such testing should include paper-based disclosure and electronic disclosure.

6.8. Foreign exchange costs including the currency conversion rates and costs should be included in transaction costs (either investment product and/or investment service costs).

6.9. The use of terminology should be consistent. For example, FAIR Canada notes that the Discussion Paper refers to "Financial Advice" in the account statement sample disclosure, whereas it is more appropriately disclosed in the Figure Three Compensation Report as "Trailing commissions". In Figure 4, Cost and Compensation Report for an Integrated Member it is not separately disclosed (which we oppose) and is referred to as "financial advice" in the "Ongoing cost of owning Investment Funds" line item, in the footnote.

7. Response to Discussion Questions

Expanding Cost Reporting

Question 1: Should regulators consider expanding cost reporting for Investment Funds?

For the reasons discussed above yes, but it should not just be for investment funds and any expansion must be done because it increases investor protection and contributes to better investor outcomes rather than is conveniently reported a certain way due to firm business models.

Question 2: Should regulators consider expanding cost reporting for other investment products?

For the reasons discussed above, yes. However, those investment products that are not deemed to be securities and that may have lesser disclosure requirements should not be used as an excuse to not improve disclosure for investments costs that are related to securities.

Costs Considered for Expansion

Question 3. Do you agree that the costs considered in this Discussion Paper (i.e. MER, short-term trading fees, redemption fees and client costs paid directly to third parties) should be disclosed to clients?

FAIR Canada believes that expanding cost disclosure must be done thoughtfully so that it is helpful to investors and it must be clear that expanded disclosure improves investor's understanding of the costs for investment advice and services, the costs of investment products and the amount of compensation that the dealer receives (third party payments such as trailing commissions and deferred sales charges). At present, we do not know if the specific costs that the MFDA wishes to include in the cost disclosure will diminish or improve investors' understanding and whether other alternatives are preferable. A review of leading international jurisdictions, such as the European Union, the United Kingdom and Australia, should be undertaken to see the purposes of their disclosure, the approaches they have taken and their impact on investor understanding and behaviour.

FAIR Canada believes that the "total cost" approach of integrated dealers that does not disclose the amount of trailing commission and therefore, does not inform investors of the amount of compensation received by the dealer firm, is contrary to the goals of CRM2.

Question 4. Are there any other costs that should be reported to clients?

If the goal is "total costs" then all costs should be reported. However, whether separate itemization is necessary is highly debatable because the simplicity of presentation and the quality of disclosure should be valued more than the quantity of items disclosed.

Again, FAIR Canada recommends international benchmarking to learn best practices from other jurisdictions. FAIR Canada has mentioned, above, foreign exchange fees and conversion costs as costs which should be included in costs and potentially presented in any detailed reporting. Benchmarking should be done on disclosure of taxes and their impact on costs and returns.

Cost Reporting

Question 5: What are your views on the reporting examples provided in this Discussion Paper?

Please see above. We believe that this initiative is not at the stage where examples should be generated. Regulators need to reflect on the policy goals of expanding cost disclosure, the optimal means of achieving these goals and considering factors such as what the impacts will be of the CSA's Reforms to Enhance the Client-Registrant Relationship as well as the CSA's Mutual Fund Fee Reforms. The focus should be on the best interests of investors and improving investor protection and investor outcomes.

Question 6: Are there better ways to report the costs of investing to clients?

See above, yes.

Question 7: What challenges or issues do you foresee in obtaining and reporting expanded cost information to clients?

No comment at this time.

Question 8: Are there different challenges or issues to expanding cost reporting for investment dealers or other securities registrants?

We do not think that the business model should stand in the way of a requirement to provide investors with meaningful information on their total costs. The focus should be on the best interest of the investor as this will lead to a more professional, competitive industry in which investors have confidence.

Implementation

Question 9: Based on the cost reporting approaches detailed in this Discussion Paper, what would be a realistic time-frame for implementing expanded cost reports to clients?

We think it is not possible to estimate at this time a time frame as the cost reporting approaches in the Discussion Paper need further work for the reasons discussed in our comments above.

Implementation should not occur until the issues discussed above have been worked through, including testing of proposed disclosure with investors.

8. Conclusion

8.1. FAIR Canada supports disclosure that lets investors know what costs they have incurred (regardless of the type of investment or registrant) and what impact those costs have on their investment returns. We urge the CSA, MFDA and IIROC to benchmark to leading jurisdictions, and to test proposed disclosure with investors so that disclosure is in the best interests of investors. "How" costs are disclosed should be given as much consideration as "what" costs are disclosed. Quality, simplicity and comprehensibility need to be key considerations as well as likely impact on investor decision-making and behaviours.

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 Frank Allen at 647-256-6693/frank.allen@faircanada.ca or Marian Passmore at 647-256-6691/ marian.passmore@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights

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