

July 04, 2020

The Secretary  
Ontario Securities Commission  
20 Queen Street West  
22<sup>nd</sup> Floor  
Toronto, Ontario M5H 3S8  
[comments@osc.gov.on.ca](mailto:comments@osc.gov.on.ca)

**RE: Ontario Securities Commission (OSC) Notice and Request for Comment – Proposed OSC Rule 81-502 Restrictions on the Use of the Deferred Sales Charge Option for Mutual Funds (OSC Proposed Rule)**

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FAIR Canada<sup>1</sup> is pleased to provide comments on the OSC Proposed Rule that has been published for public comment and is intended to address investor protection issues arising from deferred sales charges (DSCs) in the sale of mutual fund securities as described in the OSC Notice issued February 20, 2020 (OSC Notice)<sup>2</sup>.

## 1. General Comments

- 1.1. **FAIR Canada has advocated for a regulatory ban of DSCs for many years and supports the announcement of December 19, 2019 by the Canadian Securities Administrators (CSA) to prohibit DSCs and associated redemption fees in all jurisdictions in Canada other than Ontario.<sup>3</sup> FAIR Canada believes that DSC mutual funds have hindered many Canadians from being able to effectively and efficiently save for their retirement and other financial goals. FAIR Canada also believes the use of DSCs creates conflicts of interest between the interests of the investment advisor**

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<sup>1</sup> 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.

<sup>2</sup> OSC Notice and Request for Comments [https://www.osc.gov.on.ca/documents/en/Securities-Category8/rule\\_20200220\\_81-502-rfc-deferred-sales-charge-option-mutual-funds.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category8/rule_20200220_81-502-rfc-deferred-sales-charge-option-mutual-funds.pdf)

<sup>3</sup> CSA Staff Notice 81-332 [https://www.osc.gov.on.ca/documents/en/Securities-Category8/csa\\_20191219\\_81-332\\_next-steps-proposals-prohibit-certain-investment-fund-embedded-commissions.pdf](https://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_20191219_81-332_next-steps-proposals-prohibit-certain-investment-fund-embedded-commissions.pdf)

**recommending the purchase of such securities and the best interests of many investors.<sup>4</sup>**

- 1.2. FAIR Canada has advocated for a regulatory best interest standard to better ensure advice provided to investors by the financial services industry is focused on what is best for investors, rather than what is financially best for investment fund manufacturers, financial services representatives and their dealer firms.
- 1.3. As noted in the OSC Notice, embedded commissions raise conflicts of interest that misalign the interests of investment fund managers, dealers and representatives with those of investors, which can impair investor outcomes. Embedded commissions generally do not align with the services provided to investors.
- 1.4. As we stated in our December 13, 2018 submission to the CSA<sup>5</sup> regarding the consultation on proposals to amend mutual fund sales practices:
  - a. Embedded commissions and DSC mutual funds have hindered the savings goals of many small investors and should be banned.
  - b. Choices of payment structure for “advice” are made based on the revenue requirements of dealers and representatives, **not** based on the best interests of the client.
  - c. Many industry players support a ban on DSCs.
  - d. DSCs are a form of embedded commission that needs to be prohibited. They are rife with conflicts of interest, target the most vulnerable investors and there is strong evidence of mis-selling, in addition to the DSC funds themselves being suboptimal investment vehicles for investors.
- 1.5. FAIR Canada has continued to advocate for the elimination of the DSC, noting that these charges are abusive to investors.<sup>6</sup>
- 1.6. Most recently, FAIR Canada has called on the financial services industry to recognize the substantial financial hardship that the COVID-19 pandemic has presented to many Canadians.<sup>7</sup> Specifically, with respect to mutual fund DSCs, FAIR Canada has advocated for the financial services industry to suspend redemption fees when clients who are facing financial hardship withdraw money from or transfer investments between DSC mutual funds.

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<sup>4</sup> <https://faircanada.ca/submissions/fair-canada-welcomes-the-csa-ban-on-embedded-commissions-for-mutual-funds/>

<sup>5</sup> <https://faircanada.ca/submissions/csas-proposed-amendments-to-ni-81-105-mutual-fund-sales-practices/>

<sup>6</sup> <https://www.theglobeandmail.com/investing/article-advocates-call-for-end-to-early-withdrawal-fees-on-mutual-funds/>

<sup>7</sup> <https://faircanada.ca/wp-content/uploads/2020/04/Newsflash-FAIR-Canada-calls-for-suspension-of-DSC-mutual-fund-redemption-fees-March-2020.pdf>

- 1.7. The OSC Proposed Rule introduces restrictions on the use of DSCs. These restrictions are intended to mitigate negative investor outcomes, including the “lock-in” effect of redemption fees, associated with DSC mutual funds and to reduce mis-selling, while continuing to allow dealers to offer DSC mutual funds to clients with smaller accounts.
- 1.8. FAIR Canada has long been an advocate for fee reform in the mutual fund industry. DSCs are a form of embedded commission that produce conflicts of interest, target vulnerable investors, impede the ability of investors to achieve reasonable investment returns and savings, and do not result in investors receiving meaningful advice (which is often the justification for charging these fees).
- 1.9. FAIR Canada acknowledges the OSC efforts to protect Ontario investors from the most egregious harms caused by DSCs by the measures contained in the OSC Proposed Rule given the position of the Ontario government announced on September 14, 2018 that the government does not agree with the Canadian Securities Administrators’ [proposed amendments](#) to ban the deferred sales charge (DSC) option.

### Comments on Specific Restrictions of OSC Proposed Rule

We offer the following comments on the specific restrictions contained in the OSC Proposed Rule and the specific consultation questions relating to the OSC Proposed Rule in Annex D of the OSC Notice.

## 2. Investment Fund Manager Restrictions

### Maximum Term of DSC Redemption Fee and Effective Date of OSC Proposed Rule

- 2.1. The OSC Proposed Rule will eliminate DSC’s on the redemption of a mutual fund that occurs more than 3 years after its initial purchase (Maximum Term). This will lower potential redemption fees paid by investors in these investment products. However, **we note that the OSC Proposed Rule has an effective date of June 1, 2022 and will permit DSC redemption schedules for mutual fund sales that take place prior to the proposed effective date to continue unaltered.** Some DSC mutual funds have redemption schedules that will result in DSC charges for as long as 7 years. **This means that an investor buying a DSC mutual fund in May 2022 could end up paying these charges until as late as May 2029. This puts smaller investors, who are most likely to invest in DSC funds, at the risk of harm for almost another decade following the decision of regulators to address problems associated with DSC mutual funds.** Given the OSC is taking a different approach than other CSA jurisdictions in Canada, and given the ongoing extensive harm caused by these investment products to investors in Ontario, **we recommend that the OSC**

**Proposed Rule, in particular the restriction on the Maximum Term, should become effective on December 31, 2020.** There does not appear to be any operational or other significant transitional issues that prevent the mutual funds industry from being able to comply with this restriction and enhancement of investor protection on a much more timely basis.

- 2.2. **FAIR Canada also recommends that the language of the OSC Proposed Rule be more precise on the rate at which the DSC should decline over the 3 year time frame they are permitted.** Specifically, the OSC should require the amount of the DSC to decline at an equal amount over the 3-year period in which it can be charged. For example, if you have a DSC of 3% for a redemption in the first year, that DSC would decline by 33% to a 2% DSC for a redemption in the second year and to a 1% DSC for a redemption in the third year, with no DSC after 3 years. The lack of specificity on the OSC Proposed Rule, as drafted, has the potential to permit a wide range of options that has the potential to incent inappropriate behavior by advisors selling these DSC mutual funds.

### **Redemption of 10% of Value of Investment Without Redemption Fees**

- 2.3. FAIR Canada is supportive of the intent behind the OSC Rule Proposal to permit mutual fund investors to redeem 10% of their investment per year without incurring redemption fees and to allow investors to carry forward any unused allowance. However, while this proposal seeks to reduce certain negative implications of DSCs for investors, this proposal only codifies existing industry practice. It is unclear what new or additional impact this would have on investors protections and reducing the harms due to the “lock-in” effects of redemption fees. **FAIR Canada recommends, therefore, that the threshold for withdrawal without redemption fees in the OSC Proposed Rule should be increased to 20% per year from 10%.**
- 2.4 The current pandemic and the corresponding high unemployment and economic disruption demonstrate the need for greater flexibility for Ontarians who have a lower income and are smaller investors.

### **Cross-Subsidization**

- 2.5 As noted in Annex D of the OSC Notice, an earlier CSA consultation noted that some investors indirectly subsidize certain dealer compensation costs that are not attributable to the investors’ investment in a mutual fund, which means the investors pay excess fees. While mandating a separate DSC series may help in curtailing cross-subsidization, FAIR Canada suggests that the OSC weigh the benefit to investors against the additional costs of a separate DSC series that may be passed on to investors.

### 3. Dealer Restrictions

#### No Sales of DSC Option to Clients Over Age 60

- 3.1. FAIR Canada supports the OSC's proposal to eliminate the sale of DSC mutual funds to investors 60 years of age or over. However, there are other vulnerable investors to whom sales of DSC mutual funds would be equally inappropriate and FAIR Canada suggests the language of the OSC Rule Proposal should be broadened to reflect this. Some examples of vulnerable investors who should not be sold DSC mutual funds include: investors with cognitive impairment including dementia and investors with terminal illnesses or medical conditions that suggest that such investors may not live long enough to redeem the mutual fund investment at a time when the DSC fees can no longer be charged.

#### Maximum Client Account Size \$50,000

- 3.2. Limiting the DSC option to clients with a maximum client account size of \$50,000 will limit the overall amounts of the incentives paid by fund organizations to dealers and representatives for the sales of DSC mutual funds and will limit the overall amount of this investment product type sold in Ontario's capital markets. **FAIR Canada believes that this restriction along with the other measures introduced by the OSC Proposed Rule will act as a disincentive and limit the financial industry's interest in selling this type of product.** We note that several mutual fund and investment dealers have recently announced they are discontinuing the selling of DSC mutual funds.<sup>8</sup>
- 3.3. That said, there remains a concern that by permitting the sale of DSC mutual funds to small investors, the regulations impose the highest financial burden on investors who can least afford it, without any evidence that they are receiving meaningful advice much less benefiting from the advice received.
- 3.4. The OSC's Investor Advisory Panel (the IAP) conducted a survey of Canadians on the advice they received. The results of the survey were published in July 2019.<sup>9</sup>
- 3.5. Among the key findings from the IAP study are the following:

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<sup>8</sup><https://faircanada.ca/submissions/csas-proposed-amendments-to-ni-81-105-mutual-fund-sales-practices/>, <https://www.advisor.ca/news/industry-news/bmo-to-discontinue-dsc-funds-later-this-year/>, <https://www.advisor.ca/news/industry-news/nei-will-discontinue-dscs-this-year/>

<sup>9</sup> OSC Investor Advisory Panel, "A Measure of Advice: How much of it do investors with small and medium-sized portfolios receive?", July 2019, online: [https://www.osc.gov.on.ca/documents/en/Investors/iap\\_20190729\\_survey-findings-on-how-much-advice-investors-receive.pdf](https://www.osc.gov.on.ca/documents/en/Investors/iap_20190729_survey-findings-on-how-much-advice-investors-receive.pdf)

- *60% of mass-market investors and 75% of investors with small portfolios reported that their advisor communicated with them in the past year only “once or twice” or did not communicate at all.*
  - *Nearly half (49%) of mass-market investors said their advisor spent less than an hour, in total, communicating with them during the past year or didn’t communicate at all. Two-thirds (68%) of small investors and 44% of mass-affluent investors said the same thing.*
- 3.6. While smaller investors appear to be paying for advice, it does not appear that many of them are receiving meaningful advice. If we take a hypothetical example of \$25,000 invested with a DSC fee of 5% for redemption (or sale of mutual fund units) in the first year and an investor who redeems this investment within that first year, the investor will be paying \$1,250 for, potentially, 30 to 60 minutes of an advisor’s time.
- 3.7. The OSC Proposed Companion Policy to the Proposed Rule (Proposed Companion Policy) states the OSC is of the view that: “there is an inherent conflict of interest for registrants to accept upfront commissions associated with the sale of mutual fund securities under the deferred sales charge option.” The Proposed CP goes on to indicate it is an expectation that registrants address this conflict of interest by implementing policies and procedures sufficient to mitigate the risk to clients’ interests and to closely monitor for compliance with the policies and procedures, the OSC Proposed Rule, and obligations when making suitability determinations in the course of providing investors with investment advice.
- 3.8. Given the evidence that the investors who most need advice from dealers and advisors do not appear to be getting that advice, we recommend that more explicit expectations around documenting advice and suitability determinations with clients may be one constructive way to address this inherent conflict of interest. At a minimum, advisors should be recording the amount and type of advice received by investors.
- 3.9. FAIR Canada would also recommend that an assessment of the effectiveness of the policies and procedures implemented by registrants to address the inherent conflict of interest articulated in the Proposed Companion Policy, should be incorporated into business conduct compliance examinations and reviews of registrants that are conducted by the OSC and the self-regulatory organizations.

### **Clients Cannot Use Borrowed Money to Purchase DSC Mutual Funds**

- 3.10. **Borrowing money to invest is risky and borrowing money to invest in DSC mutual funds is simply not suitable for retail investors.** FAIR Canada supports the ban on

the use of borrowed money to purchase mutual funds with the DSC option contained in the OSC Proposed Rule. **FAIR Canada has advocated against the leveraged sale of mutual funds, such as DSC mutual funds, for many years.**<sup>10</sup>

- 3.11. Investments in any mutual funds using borrowed money are not a rational investment strategy for retail investors and are invariably unsuitable for all but the most sophisticated of investors with high risk tolerance investor profiles. Of course, sophisticated investors who are knowledgeable about the market would not use borrowed money to invest in mutual funds. There are better low fee investment products such as ETFs available for sophisticated investors who want to speculate on the market direction or a sector direction.
- 3.12. In addition to not being a valid investment strategy, the increased market risk makes leveraged purchases of mutual funds unsuitable for retail investors. Borrowing money to purchase typical mutual funds greatly increases risk.
- 3.13. Negative market returns would likely result in even greater negative investment returns resulting in compounded losses for the investor. For example, a market loss of 20% with the mutual fund loss of 22% (the market loss plus 2% MER) would result in 22% loss on the value of the original investment and approximately 27% loss on the borrowed money (market loss plus MER plus cost of loan assuming a 5% interest rate).
- 3.14. Bear markets (a loss of 20% or more) historically occur every 3 to 5 years. Statistically, based upon the 20% minimum loss for a market correction in a bear market, a leverage investment strategy would produce a loss of approximately 50% of the value of the original investment while the advisor or dealer and the financial institution that provided the loan have all profited handsomely.
- 3.15. While the leveraged purchases of mutual funds makes no sense from the perspective of a retail investor, it is highly lucrative for dealers and registered advisors and dealer representatives. Convincing unsophisticated investors to borrow 100% or more of their original investment amount, increases the fees paid to the dealer/advisor/representative by 100%. Simply stated such practices are predatory.
- 3.16. We are still in what may be the early stages of the COVID-19 pandemic and it is unclear what the medium and long-term impact this pandemic will have on the perfor-

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<sup>10</sup> Regulators Need to Act on Leveraged Investing - FAIR Canada <https://faircanada.ca/submissions/leveraged-investing/>; IIROC Guidance on Borrowing for Investment Purposes - FAIR Canada <https://faircanada.ca/submissions/iiroc-guidance-on-borrowing-for-investment-purposes/>; MFDA Leverage Suitability - FAIR Canada <https://faircanada.ca/submissions/mfda-leverage-suitability/>

mance of mutual funds, but using leverage, particularly in the current market environment, to purchase funds, let alone DSC funds, is not suitable. Any form of leverage greatly increases risk when market returns are negative. For smaller retail investors, losing a portion of their investment while still being required to pay all of the funds borrowed to make that investment would be financially devastating. Eliminating the use of borrowed money to purchase mutual funds (DSC or otherwise) is a positive, necessary and long overdue step.

### Financial Hardship

- 3.17. FAIR Canada supports the OSC's Rule Proposal to eliminate DSC charges in circumstances of investor financial hardship. **We recommend that the OSC's Rule Proposal should be drafted to provide for a financial hardship exemption in circumstances "including by not limited to" death, involuntary loss of employment, disability and critical illness.** The COVID – 19 pandemic has had a tremendous economic impact, hitting the most vulnerable the hardest. Smaller investors can least afford DSCs at this challenging time in order to access their own savings. Many small business owners and independent contractors (reflecting the increased prevalence of the gig economy for many Canadians) have lost business or contracts as a result of this pandemic. Accordingly, **FAIR Canada recommends that the OSC have a broader financial hardship exemption.**

## 4. Other Comments

- 4.1. **Market Impact** - FAIR Canada believes the OSC Rule Proposal makes considerable progress in addressing the problematic issues that DSCs present. However, by taking a different approach from the other members of the Canadian Securities Administrators (the "CSA"), Ontario creates the potential for confusion amongst the investing public and the investment community. The OSC Rule Proposal creates a less consistent approach to regulation of DSCs in Canada.
- 4.2. FAIR Canada believes that the OSC Rule Proposal in conjunction with the CSA ban of DSCs in other jurisdictions in Canada, will inevitably lead to the reduced sale of DSC mutual funds in the market due to many factors, including the costs of ensuring appropriate compliance with the OSC Proposed Rules, resulting in this investment product becoming unattractive to the investment industry. We note that since the publication of the CSA Staff Notice to impose a ban on DSCs in all jurisdictions other than Ontario and the OSC Notice regarding the OSC Proposed Rule, several financial institutions have announced they will no longer sell DSC mutual funds.<sup>11</sup>

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<sup>11</sup> Footnote 8, supra



- 4.3. **Segregated Funds** - The OSC's proposal, taken together with the ban on DSCs by other securities regulators in Canada, will limit the ability of mutual fund dealers to use DSCs. Segregated funds, however, are regulated by insurance regulators and continue to be able to use such fees. In the short term, timely collaboration between regulators is necessary to ensure that investors receive the same protections and eliminate potential regulatory arbitrage. Longer term, FAIR Canada would like to see the OSC regulate segregated funds.
- 4.4. **Dealers' Obligation to Document Rationale for Recommending DSCs** - After-the-fact adjudication of disputes and complaints involving unsophisticated investors can be difficult. In the context of disputes and complaints over DSCs, investors (particularly less sophisticated and experienced investors) may not be capable of marshaling evidence to support a clear and compelling complaint. Documentary evidence of interactions between investors and their financial advisors can be critically important in DSC-related complaints. FAIR Canada therefore recommends that the OSC Proposed Rule include a requirement that mutual fund and investment advisors must document the rationale for the selection of the DSC option mutual fund investment, which includes details of other options considered and the best interests of the client.

FAIR Canada would like to endorse the comments made by the OSC's Investor Advisory Panel, the Small Investor Protection Association, the Canadian Advocacy Council of the CFA Societies Canada and Vanguard Investments Canada in their submissions in response to the OSC Notice.

We thank you for the opportunity to provide our comments and views in this submission. We welcome the public posting of this submission and would be pleased to discuss this letter with you. Please feel free to contact Doug Walker should you have any questions or require further explanation at [douglas.walker@faircanada.ca](mailto:douglas.walker@faircanada.ca).

Sincerely,



Douglas Walker  
Deputy Director  
Canadian Foundation for Advancement of Investor Rights