

CSA Staff Notice 81-327

Next Steps in the CSA's Examination of Mutual Fund Fees

June 29, 2016

Purpose

In 2015, the Canadian Securities Administrators (the CSA or we) committed to communicating a policy direction on mutual fund fees by the first half of 2016.¹

After thorough examination, the CSA find that 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 (embedded commissions) raises a number of investor protection and market efficiency issues that suggest a need to consider change. We believe there is considerable scope for better aligning the interests of investment fund managers and dealers/representatives with those of the investors they serve.

Several CSA initiatives may help address some of these concerns. Already in place are disclosure enhancements under the Client Relationship Model (Phase 2) reforms and new point of sale disclosure requirements for mutual funds. The CSA are also consulting on proposals to improve the client-registrant relationship outlined in CSA Consultation Paper 33-404 *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward their Clients* (CSA CP 33-404).

This Notice communicates that, while the CSA continue to evaluate and monitor these initiatives, we have decided to consult on the further option of discontinuing embedded commissions and transitioning to direct pay arrangements that:

- directly engage investors in the dealer/representative compensation process,
- deliver greater clarity on the services provided and their costs, and
- better align the interests of fund industry participants and investors.

Discontinuing embedded commissions would be a significant change for investors and the mutual fund industry. Therefore, before considering any rule proposals on mutual fund fees, the CSA wish to consult on the impact such a change could have on Canadian investors and market participants and on the ways in which any negative impacts could be mitigated through the design and implementation of potential transition measures. The CSA expect to issue a consultation paper in the fall of 2016.

Background

The CSA have completed the following consultations and commissioned the following research² examining investor protection and market efficiency issues that arise from embedded commissions:

¹ See CSA release dated October 22, 2015 available at: <https://www.securities-administrators.ca/aboutcsa.aspx?id=1386>

² The written consultations and research reports are available on the websites of the members of the CSA.

- CSA Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees* published on December 13, 2012;
- Roundtable consultation³ and discussion forums⁴ on mutual fund fees held in 2013;
- CSA Staff Notice 81-323 *Status Report on Consultation under CSA Discussion Paper and Request for Comment 81-407 Mutual Fund Fees* published on December 19, 2013;
- *Mutual Fund Fee Research* by the Brondesbury Group published on June 11, 2015; and
- *A Dissection of Mutual Fund Fees, Flows, and Performance* by Douglas Cumming, Sofia Johan and Yelin Zhang, from the Schulich School of Business, published on October 22, 2015 and updated February 9, 2016.

After an extensive review of these inputs, in addition to many other independent studies substantiating the detrimental impact of conflicts from embedded commissions on investors and market efficiency, the CSA have determined that there is sufficient evidence to consider regulatory action on embedded commissions. However, before taking any action, and while we consider related regulatory initiatives underway, we want to consider the impact that discontinuing embedded commissions could have on the provision and accessibility of advice and on certain product providers in our market. The CSA have therefore decided to consult with stakeholders on potential measures to transition to direct pay arrangements (under which the investor would agree to and pay directly the dealer/representative's compensation) and our assessment of the potential consequences of such regulatory action on Canadian market participants and investors.

Consultation Paper

The consultation paper will build on our previous consultations and the important body of research we have considered to date. It will assess the potential quantitative and qualitative consequences of discontinuing embedded commissions on different types of market participants and different types of investors in Canada. In particular, it will:

- evaluate the extent to which the adoption of direct pay arrangements would address the investor protection and market efficiency issues that have been identified;
- provide an overview of existing tools and related regulatory initiatives underway and consider the extent to which they respond to the issues identified;
- assess the potential impact of discontinuing embedded commissions on:
 - market structure and business models, and
 - access to advice for investors;

³ See transcript of Ontario Securities Commission roundtable held June 7, 2013 available at: http://www.osc.gov.on.ca/documents/en/Securities-Category8/rpt_20130607_81-407_mutual-fund-fees-roundtable.pdf

⁴ The British Columbia Securities Commission and Autorité des marchés financiers held discussion forums in the summer and fall of 2013, respectively.

- review the progress of similar regulatory reforms in other jurisdictions and assess how those markets are similar to or different from Canada's; and
- identify various transition options that could be employed to implement a move to direct pay arrangements.

In addition to consulting on the option of mandating a transition away from embedded commissions, the consultation paper will provide an explanation of other options considered by the CSA and the reasons why those options are no longer being considered.

We invite stakeholders to take note of this upcoming publication. The CSA will specifically be looking for submissions in response to the consultation paper that provide analysis and perspectives that

- were not raised in the prior consultations, and
- wherever possible, are founded on data or other evidence specific to the Canadian market.

The comment period for the consultation paper will run for a period of 120 days. We encourage commenters to consider the consultation paper in conjunction with proposals to improve the client-registrant relationship outlined in CSA CP 33-404, currently out for comment.

Following the publication of the consultation paper, the CSA will hold roundtables to further discuss the potential impacts of discontinuing embedded commissions in the Canadian context and possible transition options. We encourage all stakeholders to engage in this process.

Questions

If you have any comments or questions, please contact any of the CSA staff listed below.

Kathryn Anthistle
Senior Legal Counsel
Legal Services, Capital Markets Regulation
British Columbia Securities Commission
Tel: 604-899-6536
kanthistle@bcsc.bc.ca

Chantal Mainville
Senior Legal Counsel
Investment Funds and Structured Products
Ontario Securities Commission
Tel: 416-593-8168
cmainville@osc.gov.on.ca

Wayne Bridgeman
Deputy Director, Corporate Finance
The Manitoba Securities Commission
Tel: 204-945-4905
wayne.bridgeman@gov.mb.ca

Danielle Mayhew
Legal Counsel
Alberta Securities Commission
Tel: 403-592-3059
Danielle.mayhew@asc.ca

Melody Chen
Senior Legal Counsel
Legal Services, Corporate Finance
British Columbia Securities Commission
Tel: 604-899-6530
mchen@bcsc.bc.ca

George Hungerford
Senior Legal Counsel
Legal Services, Corporate Finance
British Columbia Securities Commission
Tel: 604-899-6690
ghungerford@bcsc.bc.ca

Heather Kuchuran
Senior Securities Analyst
Financial and Consumer Affairs Authority of
Saskatchewan
Tel: 306-787-1009
heather.kuchuran@gov.sk.ca

Hugo Lacroix
Senior Director, Investment Funds
Autorité des marchés financiers
Tel: 514-395-0337, ext. 4461
Toll-free: 1-800-525-0337, ext. 4461
hugo.lacroix@lautorite.qc.ca

John Mountain
Director
Investment Funds and Structured Products
Ontario Securities Commission
Tel: 416-593-3360
jmountain@osc.gov.on.ca

Andrew Papini
Legal Counsel
Investment Funds and Structured Products
Ontario Securities Commission
Tel: 416-263-7652
apapini@osc.gov.on.ca

Mathieu Simard
Senior Advisor, Investment Funds
Autorité des marchés financiers
Tel: 514-395-0337, ext. 4471
Toll-free: 1-800-525-0337, ext. 4471
mathieu.simard@lautorite.qc.ca

Dennis Yanchus
Senior Economist
Strategy and Operations – Economic Analysis
Ontario Securities Commission
Tel: 416-593-8095
dyanchus@osc.gov.on.ca