CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Staff Notice 81-330
Status Report on Consultation on Embedded Commissions and Next Steps

June 21, 2018

Introduction

On January 10, 2017, the Canadian Securities Administrators (the **CSA** or **we**) published for comment CSA Consultation Paper 81-408 *Consultation on the Option of Discontinuing Embedded Commissions* (the **Consultation Paper**). The purpose of this notice is to provide a summary of the consultation process and the feedback received, and to announce the CSA's policy decision and next steps.

Executive Summary

In the Consultation Paper, the CSA identified and discussed three key investor protection and market efficiency issues arising from the prevailing practice of investment fund managers remunerating dealers and their representatives for mutual fund sales through commissions, including sales and trailing commissions (**embedded commissions**). We also sought feedback on the option of discontinuing embedded commissions as a regulatory response to the identified issues, the potential impacts to both market participants and investors of such a change, and other alternatives that could sufficiently mitigate the identified issues.

Since the publication of the Consultation Paper, the CSA have evaluated all feedback received throughout the consultation process, including through written submissions and numerous in-person consultations. Further to our evaluation of all feedback received, we are proposing the following policy changes:

- to implement enhanced conflict of interest mitigation rules and guidance for dealers and representatives requiring that all existing and reasonably foreseeable conflicts of interest, including conflicts arising from the payment of embedded commissions, either be addressed in the best interests of clients or avoided – we refer you to the CSA Notice and Request for Comment published today, seeking comment on a proposed set of regulatory amendments (the **Proposed Amendments**) to National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**) and Companion Policy 31-103CP *Registration Requirements, Exemptions and Ongoing Registrant Obligations* **(31-103CP)**. The conflicts of interest requirements are fundamental registrant conduct obligations that protect investors, and the Proposed Amendments to the conflicts of interest requirements will raise the bar for registrant conduct;

- to prohibit all forms of the deferred sales charge option[1], including low-load options[2] (collectively, the **DSC option**) and their associated upfront commissions in respect of the purchase of securities of a prospectus qualified mutual fund; and

- to prohibit the payment of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who do not make a suitability determination in connection with the distribution of prospectus qualified mutual fund securities.

In our view, these proposed policy changes, along with several other aspects of the Proposed Amendments, will create crucial enhancements to current practices that will better align the interests of investment fund managers, dealers and representatives with those of investors, and provide greater clarity on the services provided to investors and their associated costs. In doing so, we expect that these changes will respond to each of the important investor protection and market efficiency issues identified in the Consultation Paper, while at the same time minimizing potential adverse consequences to both market participants and investors.

We anticipate publishing a CSA Notice and Request for Comment in September of this year. This notice will include rule proposals for the elimination of the DSC option and trailing commission payments to dealers that do not make a suitability determination, as well as transition measures.

Consultation Paper Background

1. *Key Issues Examined*

The Consultation Paper identified and discussed three key investor protection and market efficiency issues arising from embedded commissions, namely that:

- embedded commissions raise conflicts of interest that misalign the interests of investment fund managers and dealers and representatives with those of investors;

- embedded commissions limit investor awareness, understanding and control of dealer compensation costs; and

- embedded commissions paid generally do not align with the services provided to investors.

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[1] Under the deferred sales charge option, the investor does not pay a sales charge for fund securities purchased, but may have to pay a redemption fee to the investment fund manager (i.e. a deferred sales charge) if the securities are sold before a predetermined period of typically 5 to 7 years from the date of purchase. Redemption fees decline according to a redemption schedule that is based on the length of time the investor holds the securities. While the investor does not pay a sales charge to the dealer, the investment fund manager pays the dealer both an upfront commission (typically equivalent to 5% of the purchase amount), and a trailing commission (which, during the period of the redemption schedule, is typically lower than the trailing commission paid in respect of the front-end and no-load purchase options). The investment fund manager may finance the payment of the upfront commission and accordingly incur financing costs that are included in the ongoing management fees charged to the fund.

[2] The low-load purchase option is a type of deferred sales charge option but has a shorter redemption schedule (usually 2 to 4 years). The upfront commission and redemption fees are correspondingly lower than the traditional deferred sales charge option.

The Consultation Paper also presented research and other evidence demonstrating how embedded commissions give rise to the investor protection and market efficiency issues. More specifically, the evidence gathered showed that embedded commissions can:

- incentivize investment fund managers to rely more on payments to dealers than on the generation of fund performance to gather and preserve assets under management, which in turn can lead to underperformance and drive up retail prices for investment products;

- incentivize dealers and their representatives to sell funds that compensate them the best or focus on only those funds that include an embedded commission rather than recommend a more suitable investment product;

- due to their opacity and complexity, inhibit investors' ability to assess and manage the impact of dealer compensation costs on their investment returns; and

- cause investors to pay, indirectly through fund management fees, dealer compensation that may not reflect the level of advice and service they actually receive.

2. *Purpose of the Consultation*

The Consultation Paper sought specific feedback, including evidence-based and data-driven analysis and perspectives, to build on the CSA's previous consultations on mutual fund fees[3] and to enable the CSA to make an informed policy decision on whether to discontinue embedded commissions. Specifically, the purpose of the consultation was to:

- assess the potential impact on investors and market participants of discontinuing embedded commissions, including the potential impact on the provision and accessibility of advice for Canadian investors, as well as business models and market structure;

- identify potential mitigation and transition measures that could minimize the negative impacts of discontinuing embedded commissions; and

- identify alternative solutions that could sufficiently manage or mitigate the identified investor protection and market efficiency issues.

[3] The Consultation Paper follows the CSA's initial consultation on mutual fund fees under CSA Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees* (the **Discussion Paper**), published on December 13, 2012, where the CSA first discussed its concerns regarding mutual fund fees, including embedded commissions, and sought comments on a range of potential options, including the option of discontinuing embedded commissions, to address these issues. The Ontario Securities Commission (**OSC**), Autorité des marchés financiers (**AMF**) and British Columbia Securities Commission subsequently held in-person consultations with stakeholders over the course of the summer and fall of 2013 to probe deeper into themes emerging from the comment letters which included: (i) the role embedded commissions play in access to advice for small retail investors in the Canadian market; (ii) the nature and scope of the services received for trailing commissions; and (iii) the impact of current disclosure initiatives and whether regulatory action beyond disclosure is warranted. We refer you to 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, for an overview of the key themes that emerged from the comment process on the Discussion Paper and the subsequent in-person consultations.

3. *The Consultation Process*

The 150-day comment period on the Consultation Paper ended on June 9, 2017. We received 142 public comment letters from various industry and investor stakeholders. Approximately 84% of the comment letters we received were from industry stakeholders (including dealers, representatives, investment fund managers, industry associations and industry service providers) and approximately 16% of the comment letters were from non-industry stakeholders (including investors and investor advocates).

The CSA also engaged in extensive in-person consultations following the publication of the Consultation Paper, including registrant outreach sessions, public information sessions, meetings with individuals as well as groups of stakeholders, speaking engagements, town halls and roundtables.[4] These in-person consultations, which were held in various CSA jurisdictions over the course of 2017, provided an opportunity to gather additional stakeholder feedback. Among other topics, this feedback provided input on the impacts of discontinuing embedded commissions and on alternative measures that could respond to the issues outlined in the Consultation Paper and lessen the risk of negative consequences to the fund industry and investors.[5] In addition, the AMF and Alberta Securities Commission (the **ASC**) conducted research to gain further insight on investor perceptions.

We thank those who contributed to this consultation process by responding to our request for comments or by participating in one or more of the in-person consultations described above. We appreciate the time that stakeholders have taken to provide detailed, very extensive and thoughtful comments, including relevant data and research, to help inform our policy decision on embedded commissions. Below, we provide an overview of the comments received from fund industry stakeholders as well as investors and investor advocates.

Consultation Feedback

In the discussion that follows, we provide a summary of the comments received throughout the consultation process (i.e. written submissions and in-person consultations). We separately discuss both the majority and minority views of fund industry stakeholders and of investors and investor advocates. We then discuss some initiatives completed by the AMF and the ASC to gain further insight on investor perceptions.

1. *Fund Industry – Majority View*

The majority of fund industry stakeholders were strongly opposed to the discontinuation of all forms of embedded commissions and a mandated move to direct-pay arrangements.

Below, we outline some of the key themes put forth by this group of stakeholders that highlight why they opposed a potential ban.

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[4] The CSA held more than 40 in-person consultations in 2017 with various stakeholders.

[5] The various alternatives considered included the following: (i) standardizing or capping trailing commissions, (ii) implementing additional standards for the use of the DSC option, (iii) enhancements to disclosure documents, and (iv) requiring dealers and representatives to offer all clients the option of a direct-pay arrangement alongside an embedded commission option.

(i) *Recent and current regulatory reforms may address the key issues*

The majority were critical of the fact that this consultation came shortly after the implementation of new disclosure requirements and other proposals that are significant for the fund industry and that, in their view, may mitigate the issues identified in the Consultation Paper. These include the implementation of the Fund Facts document[6] required to be delivered at the point of sale (the **POS reforms**) and the annual report to clients on charges and other compensation paid to the dealer firm[7] (the **CRM2 reforms**), as well as the publication of a separate consultation on proposals to enhance the obligations of registrants toward their clients[8]. In this regard, some stakeholders also remarked that the implementation of the POS and CRM2 reforms have already helped improve the awareness of fund fees by investors and have led to a decline in the offering of the DSC option.

(ii) *Additional research should be completed by the CSA before moving forward*

Several fund industry stakeholders suggested that we refrain from taking any substantive regulatory action until additional work and research is completed. In this regard, we received suggestions to:

- Conduct investor surveys to assess investors' preferences regarding payment for advice and evaluate how they may react if forced to pay directly for advice, as well as further research evaluating the effect of direct-pay arrangements on investor outcomes;

- Study market forces already affecting the fund industry to assess whether investor outcomes can be improved independent of regulation. Specific suggestions included assessments of declines in fund fees and fund fee complexity (through series simplification), shifts in fund flows from series with embedded commissions to fee-based series, shifts in fund flows to exchange traded funds (**ETFs**), and technological innovations such as the growth of online advisers;

- Commission an independent consultant to complete a comprehensive cost-benefit analysis of a discontinuation of embedded commissions that considers both the tangible and intangible costs to industry participants of this change; and

- Monitor compliance with the POS reforms and CRM2 reforms, and assess their impact on the behaviour of investors and registrants before determining whether any additional reforms are necessary.[9]

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[6] The Fund Facts document discloses key information about a mutual fund, including cost and dealer compensation information such as the management expense ratio and trailing commission rates.

[7] The annual report to clients on charges and other compensation discloses the total dollar amount of trailing commission received by the dealer in connection with securities held in the client's account.

[8] CSA Consultation Paper 33-404 – *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward their Clients*, April 28, 2016.

[9] In August 2016, the CSA commenced a multi-year research project to measure the impacts of CRM2 reforms and POS reforms on investors and the industry. The research will measure outcomes related to investor knowledge, attitude and behavior, registrant practices, and fund fees and product offerings. It will cover activity from 2016 through 2019 and is expected to be completed in 2021.

(iii) *A ban may lead to significant unintended consequences for the fund industry and investors*

Many also cautioned that discontinuing all forms of embedded commissions could lead to a number of negative impacts on both fund industry stakeholders and investors that would likely outweigh the potential benefits of a ban, including:

- *Reduced payment options for investors* **–** some argued that investors should continue to have the flexibility to choose between embedded compensation and direct-pay arrangements (rather than be required in all cases to pay directly under a direct-pay model);

- *Increased concentration and reduced competition in the market* – some suggested that the discontinuation of embedded commissions may favour firms that have scale and vertically integrated financial institutions[10] that already dominate the fund industry in Canada, and significantly disadvantage smaller and independent firms as these firms may face reduced profitability[11] and be forced to either consolidate, refocus their business on other products (e.g. insurance products) or leave the industry entirely. The view shared by many fund industry stakeholders was therefore that a ban may give a greater competitive advantage to large independent and vertically integrated firms at the expense of independent investment fund managers and dealers. Many also stated that a ban may consequently lead to greater concentration and less competition in the market, which may ultimately lead to fewer product offerings, less choice for investors, potentially higher prices over time, and less market innovation;

- *Failure to address all conflicts of interest* – some also argued that a ban may fail to eliminate all possible conflicts of interest that can impact dealer recommendations and investor outcomes.[12] For example, some suggested conflicts associated with dealer affiliation, which can skew recommendations toward proprietary products, can be even more detrimental to investor outcomes relative to conflicts related to embedded

[10] The industry suggested that large vertically integrated financial institutions may be less impacted by the discontinuation of embedded commissions through their "captive dealer network", ability to cross-subsidize internally by reallocating costs and revenue streams across their range of business lines, and ability to remunerate their affiliated dealer entity through payments other than trailing commissions (such as internal transfer payments). In contrast, the industry argued independent dealer firms have no such ability to cross-subsidize the cost of their services and must assume most of their administrative and operating expenses as well as the salaries of their management and administrative staff.

[11] The industry suggested that smaller, independent dealers will face reduced profitability for a variety of reasons, including that the transition to direct-pay arrangements may require substantial changes to dealer business models, such as changes in information technology systems and in operational and compliance processes. The industry suggested that these changes will give rise to costs that may not be easily absorbed, resulting in further consolidation and vertical integration. The industry is also of the view that smaller, independent dealers who deal mostly with mass-market clients may cease to be economically viable if, in response to a ban, such clients stop using advice and the affected firms are not able to offset their loss of revenue and costs of the transition.

[12] Commenters referred to the compensation arrangements and incentives that give rise to conflicts of interest identified in CSA Staff Notice 33-318 *Review of Practices Firms Use to Compensate and Provide Incentives to their Representatives*, published December 15, 2016 (**CSA Staff Notice 33-318**).

commissions. They also noted that a ban may increase the occurrence of existing conflicts of interest associated with the use of direct-pay arrangements;[13]

- *Regulatory arbitrage* – many submitted that dually licensed dealers and their representatives may be incentivized to reduce mutual fund sales and instead increase sales of non-securities financial products with embedded commissions, including insurance (e.g. segregated funds) and banking products (e.g. GICs, principal-protected notes). It was also noted that in other jurisdictions where embedded commissions were discontinued (e.g. Netherlands, the U.K. and Australia), the discontinuation applied across all investment products including insurance and banking products;

- *Tax consequences* – many noted that direct-pay arrangements may attract GST/HST or capital gains or losses where the service fee charged is paid through periodic redemptions of fund securities from a client's account; and

- *Impacts to financial advisor recruitment and succession planning* – stakeholders also argued that a prohibition on embedded commissions may make it more difficult for new financial advisors to enter the market and build their book of business. Stakeholders argued that these advisors typically begin their career advising new investors and those with smaller amounts to invest, for whom fee-based accounts may be uneconomical. Some argued that this limitation, together with the increasing regulatory burden, will make this career choice less attractive, reduce the number of entrants to the advice profession, and impede the succession planning of retiring advisors as there may be fewer advisors to succeed the significant number of advisors that are approaching retirement.

Many also submitted that mass-market investors, i.e., those with less than $100K in investable assets, may specifically be negatively impacted by the discontinuation of embedded commissions as follows:

- *Higher costs of financial advice and potentially higher investment costs overall* – stakeholders argued that embedded commissions permit dealers and their representatives to offer advice to mass-market investors at a lower price than they would otherwise charge under direct-pay arrangements.[14] They submitted that mass-market investors would consequently be required to pay more to receive the same face-to-face financial advice that they receive today if the industry was forced to move to a direct-pay model. These higher advice costs, when combined with the ongoing cost of the product (i.e. management fees and expenses), may result in higher overall total costs of ownership

[13] For example, some commenters noted that fee-based arrangements (i.e. where investors pay their dealer a percentage fee based on their assets under administration) may be susceptible to reverse churning, which is the practice of placing an investor in a fee-based account for no reason other than to collect an ongoing advice fee, with little or no ongoing advice and service being provided to the investor.

[14] Industry stakeholders submitted that under the embedded commission model, the cost of providing advice and services to mass-market investors is subsidized by the higher net-worth investors in the fund. The potential elimination of this pooling of fees from both higher-net worth and mass-market investors may cause the price of servicing mass-market investors to increase. Fund industry stakeholders further submitted that fee-based accounts are generally more expensive to operate for a dealer than embedded commission-based accounts due to higher administration and compliance costs.

than under the current embedded commission model (to the extent the product costs are not reduced to offset the increased cost of advice);

- *Dealers may cease or reduce services for mass market accounts* – stakeholders noted that accounts below $100K may be uneconomical for several dealers to service under a direct-pay arrangement.[15] As a result, many dealers may choose to service only mid-to-higher net-worth investors, and reduce or cease offering services to mass-market investors;

- *Less access to and/or use of advice* – stakeholders argued that mass-market investors may not be able to afford the potentially higher cost of face-to-face advice under direct-pay arrangements, and may have less access to advice if dealers cease or reduce offering their services (as described above). They also argued that these investors may reduce their use of face-to-face advice due to a reluctance to pay directly for advice. In this regard, the industry submitted that investor reluctance to pay directly may be due to a perceived preference for the embedded commission model,[16] or a lack of frame of reference as to the value of financial services and resulting lack of ability to assess the reasonableness of, and negotiate, direct fees for advice. They also stated that, as a consequence of mass-market investors having less access to and/or use of advice, these investors may have lower savings available for retirement; and

- *Alternative forms of advice may not meet investor needs* – we received submissions highlighting that investors who cannot access or afford face-to-face advice, or are unwilling to pay for the cost of that advice under direct-pay arrangements, may need to turn to discount channels (that do not provide advice) or lower-cost, automated advice channels, neither of which may correspond to their needs or desires.

(iv) *Alternatives to a ban that may limit adverse consequences should be considered*

While several industry stakeholders disputed the evidence we presented in the Consultation Paper on the harms from embedded commissions, they agreed with some of the areas of concern and acknowledged that there is room for improvement. Industry stakeholders therefore urged the CSA to consider alternative solutions that they believe would improve outcomes for investors while minimizing disruption for market participants. The most common suggestions included that we:

- *Monitor compliance with, and enforce, existing fund sales practices rules* – commenters suggested that we carry out comprehensive and coordinated compliance reviews of the current rules, including compliance with existing mutual fund sales practices rules under

[15] Industry stakeholders submitted that these accounts may be uneconomic due to the loss of the cross-subsidy associated with the embedded commission model and higher operational costs of fee-based accounts, as explained in footnote 14.

[16] Certain investor surveys commissioned by the fund industry suggested that investors have an express preference for the embedded commission model versus the direct-pay model. For example, a May 2017 investor perception survey conducted by The Gandalf Group on behalf of AGF Investments Inc. found that: (i) given the choice of paying directly or indirectly for advice, 55% of investors said they prefer to pay indirectly, and (ii) if embedded commissions were eliminated and advisors were required to charge their clients directly, 24% of investors surveyed said that it would make them less likely to seek out advice.

National Instrument 81-105 *Mutual Fund Sales Practices* (**NI 81-105**) and existing registrant requirements under NI 31-103, combined with the use of enforcement to deter misbehaviour;

- *Update existing fund sales practices rules* – many suggested that the application of NI 81-105 be expanded to other, similar investment products sold in the public and exempt markets arguing that like products should be treated similarly;

- *Pursue reforms to enhance the obligations of registrants toward their clients* – many commenters also suggested we continue to pursue amendments to NI 31-103. In particular, it was suggested that we address conflicts of interest associated with all types of compensation arrangements, as well as enhance the Know-Your-Client (**KYC**), Know-Your-Product (**KYP**) and suitability requirements to require consideration of the costs of each product recommended to a client and the impact of all fees. Other suggestions included raising proficiency and continuing education standards, especially for the identification and mitigation of conflicts of interest, as well as implementing restrictions on the use of titles;

- *Focus alternative efforts on improving the financial literacy of investors through enhanced disclosure* – for example, some suggested that to give the full picture of costs that reduce a client's investment, we expand the annual report to clients on charges and other compensation paid to dealers to also include disclosure of mutual fund product costs (management fees, administration fees, trading expenses) charged to the funds held by clients;

- *Require dealers to provide a direct-pay option* – some commenters suggested that we require dealers to offer to clients direct-pay options alongside embedded fee options and to explain the implications of each choice at the time of account opening;

- *Improve the alignment between the level of embedded commissions paid and the services provided to investors* – the comments we received varied, but generally included that we: (i) prescribe a list of minimum services that dealers/representatives must provide investors in return for the embedded commissions received, (ii) enhance dealer obligations to require dealers to establish policies and procedures as well as supervisory controls to ensure that investors receive a level of advice and service that is commensurate with the compensation paid (whether that payment is embedded or not), and (iii) require dealers to enter into a service level agreement with clients that specifies the embedded fees received as well as the advice and service provided by the dealer in exchange for those fees;

- *Cap or standardize embedded commissions* – we received many comments suggesting that we take measures to control the embedded commissions paid to dealers, for example by: (i) implementing a maximum trailing commission rate (i.e. "cap") across all asset classes, or a specific rate for each type of asset class, (ii) setting, as opposed to capping, a specific rate that can be applied across all asset classes, or a specific rate for each type of asset class, or (iii) requiring an investment fund manager to standardize rates within their fund family, for example, by asset class, purchase option, and/or distribution channel;

- *Standardize naming conventions for fund series* – some suggested that standardized naming conventions for fund series could reduce complexity for investors and increase the comparability of MERs, trailing commissions and performance across fund families and fund categories, which could in turn eventually lead to more simplified mutual fund pricing;

- *Eliminate or regulate the use of the DSC option or allow its use only within established guidelines* – here the suggestions varied but included: (i) eliminating the DSC option, (ii) eliminating the traditional deferred sales charge option but maintaining the low-load purchase option, (iii) allowing the use of these options only within established guidelines (e.g. enhance suitability guidance for the DSC option to include specific reference to consideration of the client's age and investment time horizon); and/or (iv) requiring dealers rather than investors to pay redemption fees;

- *Prohibit discount brokers from receiving full trailing commissions on mutual funds* – commenters suggested that we allow only mutual fund series that do not pay trailing commissions (e.g. series F) or mutual fund series that pay reduced trailing commissions (e.g. series D paying trailing commissions of a maximum of 0.25%) in the discount brokerage channel;

- *Increase direct-to-client fund offerings* – for example, some suggested that we allow do-it-yourself (**DIY**) investors to purchase mutual funds with no embedded commissions (e.g. series F) directly from investment fund managers without the need for a dealer; and

- *Restrict representatives selling only proprietary products to the title "salesperson"* – some independent dealers suggested that dealers that sell only proprietary products should be restricted to the title "salesperson".

2. *Fund Industry – Minority View*

While the majority of fund industry commenters did not support the discontinuation of embedded commissions, a minority of representatives, dealers and investment fund managers whose business models generally do not rely on embedded commissions, supported such regulatory action. Generally, this group of stakeholders submitted that a ban would:

- reduce barriers to entry in the market to new product providers, which may increase the availability of lower-cost and innovative products in the market;

- increase cost transparency, product access, and cost competition leading to a wider range of investment products, including greater access to low-cost investment products;

- remove product bias on the part of the dealer and representative and ensure investment decisions are based on the suitability of the product rather than the compensation paid by product providers to the dealer and representatives;

- encourage representatives to focus on the quality of the product, of which cost is an important factor, potentially leading to better returns for investors; and

- provide the opportunity for representatives to highlight their value proposition and enable investors to clearly understand the costs of the services they are receiving.

3. *Investor and Investor Advocates – Majority View*

The majority of investors and investor advocates strongly supported the discontinuation of embedded commissions. Below, we outline some of the key reasons why this group favoured a ban:

- *Separation of advice costs from product costs is necessary to minimize bias and increase focus on quality* – commenters argued that the separation of the cost of advice from the cost of the investment product is essential to: (i) remove the product bias in representative recommendations, (ii) increase the representative's focus towards factors that are more aligned with the client's interest including product quality and cost, (iii) increase product and advice cost transparency and competition, (iv) reduce barriers to entry in the market and foster innovation, and (v) cause dealers and their representatives to show clients their value proposition;

- *Disclosure is insufficient to address compensation conflicts* – commenters also argued that compensation conflicts in the financial sector, such as those arising from embedded commissions, cannot be addressed through disclosure alone, even if that disclosure is prominent, specific and clear, and sets out the implications and consequences of the conflict for the client. In this regard, they argued that while the POS reforms and CRM2 reforms are worthwhile, they do not address the compensation structures that drive biased advice; and

- *A ban will not create an advice gap for mass-market investors; rather, it will lead to development of more effective options* – many stakeholders argued that a ban will provide a positive environment for the development and growth of online-advice as well as other forms of novel advice delivery, which will lead the fund industry to offer more transparent and cost-effective investment options. Some noted, however, that while a ban on embedded commissions is not expected to exacerbate an advice gap, it may result in some investors not being able to obtain advice in the form they prefer (e.g. face-to-face advice) and cause some to turn to alternative forms of advice (e.g. online-advice).

A majority of investors and investor advocates who supported a discontinuation of embedded commissions also recommended that the CSA take a number of additional regulatory actions to further enhance the advisor-client relationship, including the following:

- *Prohibit discount brokers from receiving trailing commissions on mutual funds* – commenters argued that discount brokerages should immediately be required to only offer trailing commission-free fund series (e.g. series F) and charge investors directly for the execution-only services they provide through a trade commission or other form of direct payment;

- *Adopt a statutory best interest standard and enhance NI 31-103* – some suggested that the CSA jurisdictions should adopt a statutory best interest standard along with further reforms to NI 31-103 such as the Proposed Amendments;

- *Require dealer firms that only offer proprietary products to open their product shelves* – commenters suggested that firms that currently only sell proprietary products should be required to open their product shelves to third party products in order to ensure that recommendations can be made in the interests of clients. They also called for increased compliance oversight of firms that offer a mix of proprietary and third-party products to ensure that sales incentives, compensation grids, performance targets, and internal transfer payments do not favour the sale of proprietary products;

- *Restrict representatives selling only proprietary products to the title "salesperson"* – similar to the suggestion raised by some independent dealers, it was suggested that dealers that sell only proprietary products should not be able to represent that they provide advice in the best interests of investors and that accordingly, their representatives should be restricted to the title "salesperson" to limit any potential misconception;

- *Monitor compliance with, and enforce, existing fund sales practices rules* – commenters suggested that the CSA, Investment Industry Regulatory Organization of Canada (**IIROC**) and the Mutual Fund Dealers Association of Canada (**MFDA**) take immediate action to vigorously monitor compliance with existing rules and take enforcement action where conflicted compensation arrangements fall short of regulatory requirements and/or guidance such as those outlined in recent CSA and SRO Notices;[17]

- *Update existing fund sales practice rules* – commenters suggested that NI 81-105 should be modernized to capture all the sales practices used by the industry today, and that its application should be extended to products beyond mutual funds; and

- *Address all conflicted compensation structures* – commenters also argued that all types of compensation arrangements that can distort advice should be simultaneously prohibited. This includes: (i) embedded commissions paid by third parties in respect of any security, not just mutual funds; (ii) referral fees; (iii) dealer commissions paid out of underwriting commissions; (iv) monetary or non-monetary benefits by investment fund managers to dealers and representatives in connection with marketing and educational practices currently permitted under NI 81-105; and (v) internal transfer payments made by vertically integrated firms to their affiliated dealers for the sale of investment products.

4. *Investor and Investor Advocates – Minority View*

A small minority of investors expressed concerns with a ban on embedded commissions, and agreed to a certain extent with the majority view of fund industry stakeholders. This group of stakeholders generally stated that discontinuing embedded commissions may:

- increase the cost of advice for small investors;

- fail to give investors control over advice costs as many investors with small amounts to invest will be unable to negotiate those costs;

[17] See CSA Staff Notice 33-318, MFDA Bulletin #0705-C (December 15, 2016) and IIROC Notices 16-0297 (December 15, 2016) and 17-0093 (April 27, 2017).

- reduce investors' use of advice due to a reluctance to pay for it directly and a preference for the current embedded commission model;

- force some investors to switch to alternative forms of advice which may not meet their needs;

- fail to eliminate all compensation conflicts and potentially give rise to new conflicts; and

- increase the market share of vertically integrated firms at the expense of independent firms, resulting in an increase in the distribution of proprietary products and a decrease in product choice for investors over time.

5. ***Investor Research - Insights***

In addition to the viewpoints received through written submissions and in-person consultations, the AMF and the ASC collected insights from research conducted in their respective jurisdictions in 2017.

More specifically, the AMF held three focus groups with a total of 27 individual retail investors to gain insights into investors' perceptions and knowledge about:

- the financial services they receive from their dealers and representatives;

- how their dealers are paid, how much and for what services they are being paid; and

- three common dealer compensation options (fee-based, trailing commissions and the DSC option).

The responses collected during these investor focus groups were very informative and helped the AMF better understand some investors' perceptions and viewpoints. For more details on the AMF investor focus groups, please visit the AMF website.

The ASC also conducted an online survey of Albertans that are investors, or will likely be investors within the next five years. The purpose of the survey was to assess participants' understanding of, and views on, embedded commissions. A total of 808 Albertans completed this survey. For a summary of the survey results, please visit the ASC website.

Policy Decision

Further to the CSA's consideration of the feedback received and the insights gained through our consultation process, we are proposing the following policy changes:

- to implement enhanced conflict of interest mitigation rules and guidance for dealers and representatives requiring that all existing and reasonably foreseeable conflicts of interest, including conflicts arising from the payment of embedded commissions, either be addressed in the best interests of clients or avoided – we refer you to the CSA Notice and Request for Comment published today, seeking comment on the Proposed Amendments;

- to prohibit all forms of the DSC option as well as their associated upfront commissions in respect of the purchase of securities of a prospectus qualified mutual fund (as defined in securities legislation); and

- to prohibit the payment of trailing commissions to, and the solicitation and acceptance of trailing commissions by, dealers who do not make a suitability determination in connection with the distribution of prospectus qualified mutual fund securities.

We discuss each of these proposed policy changes in further detail below, along with a discussion of related regulatory initiatives to improve disclosure as well as why we are not proposing to discontinue all embedded commissions. A discussion of the potential benefits and impacts of our proposed policy changes on investors and market participants will follow in a CSA Notice and Request for Comment that we anticipate publishing in September of this year.

1. *Enhancing conflict of interest mitigation rules and guidance for dealers and representatives*

The Consultation Paper highlighted that the payment of embedded commissions encourages suboptimal behaviour of fund market participants, including that of investment fund managers and dealers and representatives, which reduces market efficiency and impairs investor outcomes. These issues appear to be driven by the inherent conflicts of interest associated with embedded commissions. For example, we find that embedded commissions may incentivize dealers and their representatives to favour funds that compensate them the best or to focus on only those funds that include an embedded commission, at the expense of other factors such as product quality. These incentives can impact both product shelf development and client recommendations.

In our view, these are fundamental issues that misalign the interests of market participants with those of the investors they serve. We are therefore of the view that regulatory action is required to mitigate the inherent conflicts of interest associated with embedded compensation and to ensure the investor's interest is paramount. Accordingly, we are proposing enhanced conflict of interest mitigation rules and guidance for dealers and representatives through the Proposed Amendments.

Specifically, and as further outlined in Part 13, Division 2 of the Proposed Amendments to NI 31-103 published today for comment, we are proposing rule amendments that will require both registered firms and their representatives to address all existing and reasonably foreseeable conflicts of interest in the best interest of a client. If the conflict cannot be addressed in the best interest of the client, then the registrant must avoid it. We are also proposing new requirements to document the conflicts identified and how they have been addressed in the best interests of clients, and to enhance the disclosure of such conflicts to clients.

As more particularly discussed in the Proposed Amendments to Part 13, Division 2 of 31-103CP, we state our view that it is a conflict for a registrant to receive third-party compensation (including embedded commissions). Third-party compensation has been broadly defined to mean any monetary or non-monetary benefit provided, or expected to be provided, directly or indirectly to a registrant by a party other than the registrant's client in connection with the client's purchase or ownership of a security through the registrant. We will also consider

circumstances where registrants receive greater third-party compensation for the sale or recommendation of certain securities relative to others to be a conflict of interest.

Accordingly, and as further noted in the Proposed Amendments to Part 13, Division 2 of 31-103CP, to the extent a registered firm offers clients securities that provide third party compensation (including embedded commissions), we will expect registered firms to be able to demonstrate that both product shelf development and client recommendations are based on the quality of the security without influence from any third-party compensation associated with the security. We consider this a fundamental aspect of our proposal that we expect will significantly mitigate the conflicts of interest associated with third party compensation and strengthen the client-registrant relationship. In Part 13, Division 2 of 31-103CP, we also provide examples of controls that registered firms may consider to help mitigate third party compensation conflicts.

We recognize that these provisions impact the distribution of securities beyond mutual funds. We find that the identified issues are not unique to mutual funds, and therefore believe it is appropriate to apply these conflicts of interest mitigation principles to all securities distributed by a registrant. Furthermore, the enhanced conflicts of interest mitigation requirements allow for the holistic treatment of all types of conflicts arising from sales practices, compensation arrangements and other incentive practices that can bias dealer recommendations (such as those arising from the sale of proprietary products), not just conflicts arising from embedded compensation in mutual funds.

Moreover, as further outlined in the Proposed Amendments, the enhanced conflict of interest mitigation measures are accompanied by additional proposals that will further advance investors' interests. For example:

- the suitability obligation will introduce a new core requirement that registrants must put their clients' interests first when making a suitability determination. The obligation will also require a representative to explicitly consider the potential and actual impact of costs on client returns;

- the KYC rule will require a representative to gather more specific and comprehensive information relating to the client's personal circumstances, needs and objectives, risk profile, and time horizon, which will further support the enhanced suitability obligation;

- an express KYP rule will be implemented and designed to support the enhanced suitability obligation. For example, registered firms will be required to understand the essential elements of securities offered to clients, including the initial and ongoing costs of each security, the impact of those costs, as well as how each security made available to the client compares to similar securities available in the market; and

- firms will be required to make publicly available the information that potential clients would consider important in deciding whether to become a client of the firm. This disclosure would include providing general descriptions of the account types, products and services that the firm offers, the charges and other costs to clients, as well as third-party compensation associated with its products, services and accounts.

We expect that these proposals will significantly strengthen the nature of the client-registrant relationship, and will result in recommendations that better align with the client's interest. We also expect that the combined effect of these proposals will allow for the provision of advice and services that better meet an investor's needs and objectives, and over time, improve competition and market efficiency.

As also stated in the CSA Notice and Request for Comment published today, the CSA, IIROC, and the MFDA are committed to changes at the core of the Proposed Amendments which would require registrants to promote the best interests of clients and put clients' interests first. This is a fundamental change that emphasizes the client's interests in the client-registrant relationship.

2. *Discontinuing the use of the DSC option*

In our view, the conflicts of interest inherent in the DSC option give rise to a number of specific problematic practices and investor harms that warrant regulatory action. We consider, and several industry and investor stakeholders agree, that the conflicts of interest inherent in the DSC option are generally difficult to resolve in the best interests of investors and that this purchase option should therefore be eliminated.

We note that in Canada, the DSC option appears to be a relatively popular purchase option as it still forms a significant component of Canadian mutual fund assets. As at the end of December 2016, a total of 18% of mutual fund assets were held in the DSC option (with the low-load option comprising 5% of this figure).[18] We also note that the use of the DSC option tends to be an important purchase option among independent investment fund managers.[19] Additionally, we note that the Canadian fund market is quite unique in its relative reliance on the DSC option. For example, while making up almost 20% of mutual fund assets in Canada, this option makes up less than 1% of mutual fund assets in the United States and Europe.

The DSC option appears to be an attractive option for dealers and their representatives in Canada because it offers an initial commission of up to 5% of the purchase amount paid by the investment fund manager rather than the investor, plus an ongoing trailing commission. By comparison, alternative purchase options such as the front-end option generally require the dealer and investor to negotiate the initial commission, which is typically paid upfront and directly by the investor from the purchase proceeds. Today, these commissions can be as high as 5% but in most cases are less than 5% and can be as low as 0%.[20] In our view, the higher upfront and third-party nature of the compensation on the DSC option creates a conflict of

[18] With respect to the growth of these options over the last several years, we note that the amount of mutual fund assets held in the traditional deferred sales charge option increased by 3% between 2010 and 2015, and the amount of mutual fund assets in the low-load option increased by 101% over the same period. We also note that several investment fund managers have recently discontinued, or have announced that they will discontinue, the traditional deferred sales charge option.

[19] For example, in 2016 the DSC option comprised 21% of gross sales for independent investment fund managers and 31% of fund assets.

[20] We note that the initial commission paid in respect of purchases under the front-end option has generally been declining over the last several years. The decline has been due to many factors including competition among dealers (who may also be offering no-load purchase options that do not charge an initial commission).

interest that can incentivize dealers and representatives to promote the DSC option over other options that may be more suitable for investors.

The Consultation Paper highlighted several, long-standing problematic practices associated with the DSC option. For example, we noted that the use of the DSC option can lead to poor suitability assessments. A 2015 targeted sweep of MFDA Members' DSC option trading activity[21] demonstrated this, particularly with respect to senior investors. Among other practices, the sweep showed that clients were sold funds with DSC option redemption schedules that were longer than their investment time horizon, and showed that clients over the age of 70 were sold funds under DSC option arrangements.[22]

In December 2016, the MFDA identified further compensation and incentive practices that increase the risk of mis-selling funds under the DSC option.[23] MFDA enforcement files further show that the DSC option can incentivize dealers and their representatives to promote unsuitable leverage strategies or churn their client's accounts.[24]

While the DSC option may, on its face, appear to be beneficial to investors because it does not require them to pay an initial commission, it can still have a significant impact on the investor because of its impact on investor behavior. This is due to the "lock-in" feature of the DSC option created by the redemption fee that is payable on investments that are redeemed within a certain number of years of purchase (typically up to 7 years from the date of purchase for the traditional deferred sales charge option). This penalty can significantly deter investors from redeeming an investment or changing their asset allocation, even in the face of consistently poor fund performance, unforeseen liquidity events, or change in their financial circumstance. Empirical mutual fund fee research commissioned by the CSA[25] demonstrates the effect the redemption penalty may have on an investor, as it indicates that investments made under the DSC option show the lowest sensitivity to past performance out of all available purchase options analyzed.[26]

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[21] MFDA Bulletin #0670-C, 2015 *DSC Sweep Report*, December 18, 2015. See also MFDA bulletin #0705-C, *Review of Compensation, Incentives and Conflicts of Interest*, December 15, 2016, in which the MFDA identifies compensation and incentive practices that increased the risk of mis-selling funds under the DSC option.

[22] Similarly, the *Inspections Branch of the AMF* also issued an *Info-Conformite* (volume 4, number 5) in July 2015 that reported important risks of non-compliance with the KYC rules among mutual fund dealers in Quebec. In particular, certain dealers' compliance systems permitted the sale of funds with DSC option redemption schedules to investors with short investment horizons.

[23] MFDA bulletin #0705-C, Review of Compensation, Incentives and Conflicts of Interest (December 15, 2016).

[24] See for example, the cases against Enzo DeVuono, George William Popovich, Michael Darrell Harvey, Tony Siu Fai Tong, Jacqueline De Backer, Carmine Paul Mazzotta and David John Ireland.

[25] Douglas Cumming, Sofia Johan and Yelin Zhang, "A Dissection of Mutual Fund Fees and Performance", Feb. 8, 2016, http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20160209_81-407_dissection-mutual-fund-fees.pdf.

[26] Investments made under the fee-based option show the highest sensitivity, followed by the front-end option, and again followed by the no-load option (under which no initial sales commission is paid to the dealer).

Moreover, the complicated nature of this investment option can impede investor awareness and understanding of fund costs.[27] For example, investor complaints and other evidence gathered tends to demonstrate that, despite disclosure, investors may fail to appreciate that purchases under this option will be subject to a redemption fee prior to the expiry of the associated redemption schedule.

We also note that the use of the DSC option can lead to higher fund costs. This is due to the fact that an investment fund manager's cost to finance the payment of the upfront commission on purchases made on a DSC option basis is funded from the fund's annual management fees. Unless DSC option investors are segregated into a separate fund series to which the financing costs of the upfront commissions can be wholly allocated, all investors in a fund bear those financing costs irrespective of the purchase option under which they made their investment. This raises fairness concerns for investors under the front-end option who subsidize the financing costs of the upfront commission on DSC option transactions and accordingly pay higher management fees than they otherwise would.[28] Moreover, the upfront commission may not always align with the services provided to investors at the time of the sale.

In our view, the problematic practices and investor harms discussed above are significant and demonstrate the need for change. Compliance examinations, enforcement files, investor complaints, academic research and focus groups with individual investors highlight these problematic practices and the resulting harms to investors, and reinforce the need for regulatory action. Accordingly, we propose to prohibit all forms of the DSC option as well as their associated upfront commissions for purchases of prospectus qualified mutual funds (as defined under securities legislation).

We anticipate that this change will eliminate the problematic practices and investor harms associated with the DSC option, and bring with it a number of potential benefits. For example, we expect the elimination of the DSC option will remove conflicts of interest associated with this option and encourage suitability assessments that meet investors' needs and objectives, as well as increase investors' ability to make changes to their investments to improve their financial situation. We also expect that the elimination of this purchase option will decrease fund fee complexity and, by consequence, simplify the disclosure of fees, which may help improve investors' understanding and control of advisor compensation costs. We also anticipate modest declines in fund management fees and a reduction in the cross-subsidization of costs over time.

3. *Discontinuing trailing commissions where a suitability determination is not made*

The Consultation Paper highlighted concerns with fees paid for the distribution of mutual fund securities through the discount brokerage channel. Discount brokerages tend to be primarily order-takers and do not offer investment recommendations. Despite the limited services

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[27] For example, the DSC option has various features such as a redemption schedule, redemption fees, upfront sales commissions, and automatic conversion arrangements that cumulatively can be difficult for investors to understand.

[28] We note that very few Canadian investment fund managers offer a separate fund series for each purchase option. In those cases, the management fee of each fund series reflects the respective distribution costs of each series, thus reducing the cross-subsidization of commission costs between front-end and DSC option investors. The management fee rate of the DSC option series tends to be higher than that of the front-end series, thus reflecting the higher costs associated with the DSC option.

provided by discount brokerages, with few exceptions, they typically receive the same trailing commission that is provided to full-service dealers. This results in DIY investors who hold mutual fund securities through discount brokerages paying for investment advice that is not received or desired.

We note that investment fund managers have, over the last several years, attempted to respond to this issue by offering a discounted series of their funds on the discount brokerage channel. These series are typically denoted "series D" and pay a lower trailing commission than do the traditional full service retail series. We understand that the discounted pricing reflects the fact that investors who purchase through the discount brokerage channel typically make their own investment decisions and do not receive advice.

While the availability of series D has steadily increased over the last several years, we note that most investment fund managers today still do not offer a series D on their mutual fund lineup. Of those that do, we note that the series is generally only offered on a portion of their fund lineup. We also note that dealers may not make a series D option available to clients even in cases where the investment fund manager offers a series D purchase option. As a result, and as noted in the Consultation Paper, of the $30 billion held in mutual funds in the discount brokerage channel as at the end of 2015, only $4.6 billion was actually held in a discounted fund series. This suggests that 83% of mutual fund assets in the discount channel remain in full trailing commission-paying series.[29]

In our view, the fees paid by a vast majority of DIY investors in this channel do not appear to align with the execution-only nature of the services they receive. We also observe no justifiable rationale for the practice of paying discount brokerage dealers an ongoing trailing commission for the sale of a mutual fund. For example, other securities including most ETFs are commonly purchased and sold by way of an upfront transaction fee. This ongoing payment may therefore be viewed as one that incentivizes the distribution of mutual funds that pay such an ongoing fee over those that do not (i.e. a payment for shelf space), giving rise to a conflict of interest.[30] This is especially the case when the discount brokerage receives the same trailing commission as that of full-service dealers (which rate is typically intended to compensate full service dealers for the costs associated with providing investment advice). Moreover, in our view this fee also limits investor awareness and understanding of the fees associated with the purchase of such products in the discount brokerage channel.

In addition, we note that the issues discussed above are not unique to the purchase of mutual funds in the discount brokerage channel. In our view, similar issues arise in all cases where dealers who do not make a suitability determination receive a trailing commission (such as for

[29] See tables 13 and 15 on pages 39 and 41 of the Consultation Paper.

[30] We note that on April 9, 2018, IIROC published IIROC Notice 18-0075 (the **IIROC Notice**). The IIROC Notice includes guidance on the management of conflicts of interest associated with the offering of funds that pay an ongoing trailing commission to IIROC dealer members. We note that IIROC expects IIROC dealer members to make available, wherever possible, funds with a discounted trailing commission such as series D, and in instances where a discounted series is not available, to rebate the portion of the trailing commission for ongoing advice (or taking other similar steps).

example, a dealer who does not perform a suitability analysis in respect of a "permitted client" who has waived the suitability obligation).

To address potential conflicts in the discount brokerage channel and other instances where dealers do not make investment recommendations, as well as to better align the fees investors pay with the services they receive, we propose to prohibit investment fund managers from paying, and dealers from soliciting and accepting, trailing commissions (whether for advice or any other service), where the dealer does not make a suitability determination in connection with the distribution of prospectus qualified mutual fund securities.

We anticipate that these changes will bring a number of positive results for investors. In particular, we expect the reduction of conflicts of interest, as well as increased alignment between the costs paid and services provided. We also expect to see increased use of alternative, more salient forms of payment (such as trading commissions).

4. *Related Regulatory Initiatives to Improve Disclosure*

We note that on April 19, 2018, the MFDA published a discussion paper to solicit feedback from stakeholders on the potential expansion of cost reporting for investment funds (the **MFDA Discussion Paper**).[31] The MFDA Discussion Paper outlines a number of different approaches that can be integrated into existing reporting requirements with the objectives of better allowing investors to understand the ongoing costs of each investment fund they own, and their total costs of investing. We are supportive of the MFDA's efforts to consider improvements to current disclosure to meet these objectives, and expect to engage more closely with the MFDA and IIROC to advance this important initiative.

5. *Why the CSA is not banning all forms of embedded commissions*

The Consultation Paper examined the option of discontinuing all forms of embedded commissions to respond to the associated investor protection and market efficiency issues we identified.

We are instead pursuing a package of reforms that we expect will respond to each of the investor protection and market efficiency issues we identified, but at the same time, limit potential adverse consequences to market participants and investors. In this regard, we note the concerns expressed by stakeholders that discontinuing all forms of embedded commissions could lead to a range of potentially negative outcomes for both market participants and investors. Importantly, this package of reforms extends beyond conflicts of interest arising from embedded commissions, and is designed to respond to all types of conflicts that can incentivize poor registrant behavior and subvert investor interests (such as those arising from the sale of proprietary products).

Accordingly, we think that our proposed policy direction is responsive to the feedback we received, and in particular, to the common viewpoints expressed by several industry and investor stakeholders urging the CSA to:

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[31] See MFDA Bulletin #0748-P, available at: http://mfda.ca/bulletin/bulletin0748/

- adopt rules that holistically address all conflicts that can bias dealer recommendations, including conflicts from embedded commissions;

- eliminate the use of the DSC option; and

- eliminate trailing commission payments to discount brokerages.

Further to the implementation of the proposed policy changes together with the Proposed Amendments, we will monitor the extent to which these changes have addressed the key issues outlined in the Consultation Paper, including whether the management of conflicts of interests arising from embedded commissions is adequate.

Next Steps

Over the course of the 2018-2019 fiscal year, the CSA will continue to advance each of the elements of our policy decision.

In particular, in September of this year, we anticipate publishing a CSA Notice and Request for Comment that will include:

- a regulatory impact analysis, including the potential benefits and impacts of the proposed policy changes on investors and market participants;

- rule proposals for the elimination of the DSC option and trailing commission payments to dealers that do not make a suitability recommendation; and

- transition measures.

The CSA Notice and Request for Comment will provide further opportunity for meaningful input from stakeholders. Following the publication of the CSA Notice and Request for Comment, some CSA jurisdictions may hold in-person consultations to discuss the proposed policy changes.

The CSA will also consider and evaluate all feedback received in respect of the Proposed Amendments, and will continue to coordinate policy considerations between these two projects as we move forward. Additionally, we will continue to liaise with other regulators that oversee non-securities investment products on the development of our proposed policy changes.

Questions

Please refer your questions to any of the following:

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