April 12, 2013

COMMENT LETTER /SUBMISSION MUTUAL FUND FEES

CANADIAN SECURITIES ADMINISTRATORS
DISCUSSION PAPER AND REQUEST FOR COMMENT 81-407
MUTUAL FUND FEES
December 13, 2012

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The Investor Advisory Panel (IAP) is an independent body appointed by the Ontario Securities Commission in August, 2010. Our mandate is to represent the views of investors and enable investor concerns and voices to be represented to the OSC in its rule and policy making process. Our mandate centers upon our written submissions to the OSC (Ontario Securities Commission and CSA (Canadian Securities Administrators) regarding various regulatory initiatives including proposed rules and policy statements.

As members of the Ontario Securities Commission's Investor Advisory Panel (IAP), we enclose our submission regarding the Canadian Securities Administrators' (CSA) request for comment on Consultation 81-407 Mutual Fund Fees, whereby the CSA is examining the mutual fund fee structure in Canada in order to see whether there are investor protection and/or fairness issues, and to determine whether any regulatory responses are needed to address any of these issues.

The Investor Advisory Panel is pleased to submit this comment letter.

Executive Summary

Mutual funds are the foundation of Canadian investors' saving and retirement plans. Their dependency on these products gives rise to concerns about retail investor vulnerability. There is an asymmetry in knowledge, information and experience between retail investors and their financial advisor; in fact, many investors do not know how their advisors are paid. The current compensation system of embedded trailer commissions skews mutual fund recommendations. Embedded trailer commissions represent a clear conflict of interest because they align the commercial interests of the fund manufacturer and the advisor rather than those of the advisor and his/her client. Moreover, there is no correlation between these fees charged and the advice or services offered. We recommend that regulators prohibit the payment of embedded trailer commissions.

By unbundling fees for transactions and for advice, and by prohibiting trailer commissions, the clarity and robustness of advice will be increased. This will benefit not only the retail investor but will also increase competition and enhance the reputation of advisors in the industry. For the benefit of all stakeholders, we therefore recommend the prohibition of embedded commissions and the adoption of a statutory best interest standard for advisors and dealers. A similar model is being adopted in the United Kingdom and Australia and we believe it is equally appropriate in the Canadian context as well.

We also believe that, consistent and concurrently with improvements in mutual fund regulation, Canadian regulators must address the issue of mandated titles, including enhanced proficiency/credential requirements along with statutory standards of practice.

Overview of Mutual Funds in Canada

Canadian Investors Rely Heavily on Mutual Funds

Mutual funds are Canadians' most commonly held investment product. In June 2011, the average Canadian household held 36.1 % of all its investable assets in mutual funds. Nearly two thirds of Canadians hold mutual funds in their investment portfolios (70% of RRSP holdings are comprised of mutual funds). Half of all mutual funds are held by Canadians who are approaching or already in retirement. Mutual funds are thus particularly important to older Canadians.

Canadian fund Investors unaware of costs

Independent research has shown that fees are the primary determinant of a mutual fund's performance. Thus, fees are a crucial element of overall portfolio return (Ref 1). The CSA Discussion Paper cites research showing "mutual fund investors tend not to review disclosure documents for cost information and instead primarily rely on advisors to tell them about costs," and notes also that "further research indicates that many advisors do not tell their clients about costs".

Current advisor compensation structures skew mutual fund recommendations

Canadian investors rely heavily on the advice and recommendations of their advisors in purchasing investment products .They believe their advisor has a legal responsibility to ‘put the client’s best interest first’. With this as a foundation of investors’ trust in their advisors, investors find little reason to be concerned about fees and, perhaps as a result, fewer than half of advisors disclose what they are paid (Ref 2).

A study by the OSC's Investor Advisory Panel (IAP) *“Strengthening Investor Protection in Ontario - Speaking with Ontarians”* (Ref 3) conducted on behalf of the IAP and the Investor Education Fund (IEF), explored the views of more than 2,000 Ontario investors regarding their relationships with their financial advisors and how they perceive and use investment product information and advice. The study found that there is a power imbalance between advisors and retail investors. The majority of people surveyed rely on their advisor as their main source of information. However, the study found there is skepticism on the part of Ontario investors regarding the quality of advice they are receiving. While investors generally do not know how their advisors are paid, they are skeptical that advisors are acting in investors’ best interests and believe that current compensation systems influence advisors’ recommendations and advice.

Canada’s current compensation structures for the sale and distribution of mutual funds, specifically embedded commission trailer commissions, provide a strong incentive for advisors to put their commercial interests ahead of their clients (Ref 4). Canada’s current suitability regulatory regime allows advisors to provide investment recommendations that are not necessarily in the best interest of the client. In practical terms for mutual funds, this means that suitability of advice does not require consideration of the relative cost to the client of the fund despite its important role in determining performance. The introduction of a statutory best interest duty, which we have already recommended in a previous comment letter to the CSA, would go a long way toward rectifying a number of these problems, including requiring advisers to avoid, not simply disclose, conflicts of interest.

We reiterate our position that disclosure of conflicts-of-interest has proven to be an inadequate investor protection tool. The use of disclosure as a regulatory tool has clearly not delivered the required results. Prohibition, rather than mere disclosure, of conflicted compensation structures like trailing commissions is the most appropriate regulatory response.

Paying for ‘advice’

The CSA Regulators note that the payment of trailer commissions is a ‘one size fits all’ approach that does not recognize the different levels of service offered within the industry or required by the client. For instance, a full service advisor who creates written financial plans for clients and regularly monitors their accounts is paid the same trailer commission that a salesperson or discount broker receives for providing only order-taking and periodic account statements. Simply put, there is no correlation between the trailer commissions charged and the advice or services provided. This pricing system seems arbitrary for retail investors and is unfair to those professional advisors who truly add value.

Recommendations

Our recommendations are provided in the context of other regulatory initiatives such as POS disclosure for mutual funds, the Client Relationship Model, Fiduciary duty/Best interests, Fee disclosure and Performance Reporting and the use of Titles/Designations.

We recommend:

1. Enhanced Disclosure

- **We recommend that Fund Facts be delivered to the client before the sale.** Fund Facts is currently delivered after the sale so fund fees are not clearly known during the investment decision process.

- **We recommend that Fund Facts be amended so that all applicable fees are disclosed prominently.** Fund fees should be displayed as a prominent item in the fact sheet as this will increase the chances that investors will pay heed to fees and expenses. Fees should be disclosed before performance in **Fund Facts**.
- **We recommend that Fund Facts include a strong plain language warning about the potential for conflict-of-interest.** Current disclosure of fees is not well understood by investors. Setting out the potential conflict between the best interests of the investor and the best interests of the dealer/representative will increase the chances that investors will pay heed to fees, expenses and the robustness of advisor investment recommendations. This is the practice in the U.S in their Fund Summary Document.

2. *Prohibition of any form of embedded commissions*

- **We recommend all fees for services received by the dealer/representative be disclosed to the investor and open for negotiation.** Trailer commissions encourage increased sales activity and thus influence advisor behaviour. The current weak suitability standard can lead to more expensive products being sold but also to bad behaviours such as excessive leveraging and churning. It also allows dealers/representatives to avoid recommendations that would be of greater benefit to the client. If the dealer/representative operates in the client's best interests, the client has greater flexibility and more control over the services being provided to them. The advisor and the client should together decide on the nature and extent of the advice and how much the advice is worth.

- **We recommend the prohibition of payment of trailer commissions to discount brokers or any party not providing advice.** Many **Fund Facts** documents disclose that trailers are for advice and services. Although fund manufacturers pay online discount brokers a trailer, clearly no advice is or can be provided under this model. We recommend that regulators designate that a separate fund class be used for discount brokers with trailers removed. Additionally, it would be prudent for regulators to confer with the Independent Review Committees to explain how they are dealing with this governance issue.

- **We recommend that the CSA require that fund companies provide a class of funds for do-it-yourself investors that pay no trailer commissions.** F class funds, which are funds that do not have trailer commissions, are not generally available to DIY investors; however, they should be. Making them available would provide investors with more flexibility. Minimum initial investment levels should be comparable to other fund classes.

3. Cross-Subsidization

- **We recommend that the specific distribution costs incurred by each series or class of mutual fund securities be allocated only to unit holders in that specific series or class rather than be borne equally by all unit holders in the mutual fund.** The OSC has articulated the cross-subsidization issue. This potential cross-subsidization by a mutual fund's investors of the various costs associated with different purchase options may result in certain mutual fund unit holders unknowingly paying a higher management fee than would otherwise apply if investors were segregated in a separate class or series for each purchase option. This potential inequity should be addressed. If the distribution costs were allocated only to the unit holders in the specific series or class, the management fee of each series or class of a mutual fund would better reflect each class' respective distribution costs.

4. ***Actual Expenses***

- **We recommend that the CSA review the fixed rate Administration Fee disclosure practice to ensure it is fair to retail investors.** Over the past few years a fixed rate Administration Fee has become popular. While the fixed rate Administration Fee can bring some stability and predictability to the level of a mutual fund's operating expenses, it can also effectively prevent mutual fund expenses from declining as a percentage of assets as the fund grows. It also greatly reduces disclosure of several cost elements such as audit fees. More recently, we have seen requests for exemptions or amendments to require fund investors to share in any shortfalls (but not upsides). This is not fair to the retail investor and should be reviewed.

Time is of the Essence

Mutual funds are the foundation of savings and retirement plans for over 12 million Canadians. Survey after survey has demonstrated that Canadian retail investor financial competency is very limited (Ref 5). Furthermore, as the number of seniors increases in absolute and relative numbers, the need for a robust advice regime becomes more urgent. According to the 2012 Ombudsman for Banking Services and Investments' Annual Report, they continue to see that about half of the people who complain (48%) are seniors. Unsuitable investments are the #1 reason for complaint, followed by excessive leveraging as #2.

According to the 2011-2012 Investment Industry Regulatory Organization of Canada Annual Report (Ref 6), the issue of unsuitable trade recommendations “is a persistent and significant problem in the Canadian investment industry.” When this fact is coupled with asymmetric information and advisors with conflicts-of-interest, an unsafe investment environment results. Excessive fees and skewed advice combine to effectively remove the ability of Canadians to save for retirement.

We can therefore foresee that with the growing ranks of seniors, these issues will become more prevalent. As boomers age, the coming years will also see the largest-ever inter-generational transfer of wealth. The amount of money involved means that financial elder abuse and related issues are likely to grow in importance. It is therefore imperative that a statutory best interest regulatory framework be implemented to meet the needs and interests of vulnerable retail investors.

Summary and Conclusion

We believe unbundling of fees coupled with a best interests obligation will allow advice-givers to establish well-defined value propositions that are “advice based” instead of “transaction based”. We further believe that Canadians really need and deserve financial planning that is based on the financial needs and objectives of the client, not just on what constitutes a “good product”, albeit a suitable one.

Prohibiting embedded commissions outright is the most straightforward way to align the interests of both the mutual fund manufacturers and the dealer Representatives (advisors) with those of investors. Not only will this serve the retail investors receiving unbiased advice, a new regulatory regime will also serve the added benefit of distinguishing these products from others in the industry.

In closing, it seems particularly appropriate to cite the words of Glorianne Stromberg who has been a trailblazer over the past two decades in identifying the need for reform of Canadian mutual funds. In her 1998 report (Ref 7) she stated, “Permitting these capital-eroding fees will impact the need for social support systems that we simply don’t have and probably won’t be able to afford given the erosion of the tax base as the population ages”.

The Panel is also acutely aware of the fact that in the Canadian marketplace the changes we recommend are restricted to those participants who operate under the aegis of the CSA. We urge other players, notably the federal government and banking and insurance regulators, to address these same issues. It is unacceptable that investors who purchase insurance products like segregated funds and Principal Protected Notes from a non-CSA regulated dealer or advisor are subject to lower levels of investor protection.

Canadian federal and provincial finance ministers, seniors’ organizations, pension experts and corporate leaders are warning that Canadians do not have the savings that they need to retire. Mutual funds are a key component of those savings. The CSA can contribute to these efforts to avoid a pension and savings crisis for Canadians if they emulate their counterparts in the UK and Australia and act now.

We look forward to participating in the Roundtable discussions.

Sincerely,

The Investor Advisory Panel

Nancy Averill, Paul Bates, Stan Buell, Connie Craddock, Alan Goldhar, Ken Kivenko, Cary List

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Autorité des marchés financiers
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Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Yukon Territory
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Nunavut