Friday, April-12-13

The Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario M5H 3S8
Fax: 416-593-2318

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, Québec H4Z 1G3

Dear Sir/Madame

Re: **CANADIAN SECURITIES ADMINISTRATORS DISCUSSION PAPER AND REQUEST FOR COMMENT 81-407 *MUTUAL FUND FEES***

*"The Canadian Securities Administrators (CSA or we) are examining the mutual fund fee structure in Canada in order **to see whether there are investor protection or fairness issues**, and to determine whether any regulatory responses are needed to address any issues we find……. "*

The following are my brief comments on the above noted discussion paper:

It must be emphasized that global regulatory reform in this area has not been so narrowly concerned with costs and the fairness of costs, but on wider issues that frame the market for financial advice, including higher professional standards and the conflicts of interest that arise from product sales remuneration.

> From the FSA "A Review of Retail Distribution – June 2007": *We want **standards of professionalism** that inspire consumer confidence, and **remuneration arrangements that allow competitive forces to work in favour of consumers**. We want an **industry where firms** are sufficiently viable to deliver on their longer-term commitments and where, in doing so, they **treat their customers fairly**. And we need a **regulatory framework that can support these outcomes and which does not inhibit future innovation**.*

Cost comes into the equation, of course, because, inter alia, by removing conflicts of interest from the recommendation process, advisors are more likely to recommend lower cost options and fund companies are more likely to be cost competitive.

To put the cost issue into perspective:

- The risk premium on Canadian equities above bonds from 1900 to 2011, according to the Credit Suisse Global Investment Returns Yearbook 2012, was some 3.4%. An MER of 2.5%, on an equity fund, equates to some 70% of this risk premium. From 1962 to 2011 the risk premium over bonds was 0.8%, from 1987 to 2011 a negative 1.5% and from 2002 to 2011, a negative 1.8%. In other words, high investment costs dramatically skew the risk of investment against the investor, invalidating the value of the advice.

- Secondly, actively managed funds that have similar asset allocation profiles to their benchmarks are really charging exorbitant fees for the actively managed component. For example, a fund that strays, on average, 20% from index allocations is effectively 80% indexed and 20% active. Just for the sake of analysis, if we had an MER of 2.5% and added total trading costs of 0.5%, for a total cost of 3%, versus an indexed investment with total costs of 0.25%, you are really paying 14% on the 20% active component given that you should be paying no more than 0.25% for the indexed component.

This begs the question: if advisors are to be paid for the transactions they recommend, as opposed to the advice they provide, just what are they being paid for?

Separating the remuneration from the transaction not only removes the conflict but should force the advisor to look clearly at efficient structure and cost effective content for that structure. But this also requires that advisors should raise their standards, act in their clients' own best interests and take a fiduciary type responsibility for their advisory based suitability processes.

It should be clear that the only way in which an efficient market for investment advice can be strived for is to remove the conflict of interest and to improve standards so that investment advice focuses on planning, structure and content appropriate to that structure. This is what advisors and firms should be paid for. Disclosing transaction remuneration will not aide investor protection or enhance the fairness of the outcome because it neither addresses the root of the problem nor alters the driver and direction of the advice.

It must also be noted that global regulatory reform has long since acknowledged that transaction based remuneration structures do indeed pose investor protection/fairness issues. It is unclear why the CSA are using this discussion paper to attempt to establish this.

Canadian regulators, it would seem, also do not fully understand the gulf that already exists between UK and Australian standards governing retail advice and those standards applying in Canada. I use comments from the old UK FSA on its "Basic Advice" process to highlight this:

> *Basic Advice was introduced in 2005 as a new form of regulated advice that firms can use to sell charge-capped stakeholder savings and investment products with a streamlined sales and advice process. With Basic Advice, **the consumer is asked some pre-scripted questions** about their income, savings and other circumstances **to identify the consumer's financial priorities and suitability for a** stakeholder **product**, but a full assessment of their needs is not conducted nor is advice offered on whether a non-stakeholder product may be more suitable.*

This is very similar to the minimum standard Canadian KYC suitability regime. Such a limited frame in the UK was restricted to a limited range of low cost stake holder products, for what seemed obvious reasons to UK regulators.

While the current discussion paper states that "*It will be important for the CSA to consider the unique features of the Canadian market*", it is important to note that the physics and ethics of investment advice should be the same the world over. There is nothing special or different about Canadians.

Unfortunately, what is becoming more and more unique about Canada, is the hold the transaction based distribution model has on retail financial services' standards and regulation. No discussion of investor protection issues and the costs of transactions/advice can be complete without discussion of the broker and investment dealer business model (the old FSA referred to these as Managing General Agents) that houses advisors and through which mutual funds and other products are distributed. The infrastructure that houses this model can adapt, but it is likely that regulators will also need to look at ways in which regulation can be changed to allow competitive alternative structures to house fee based models.

The consultation makes four broad suggestions, only one of which deals with the problem head on:

- **Disclose transaction remuneration and separate out the transaction component from the MER**: as discussed, disclosure does not address the root of the problem, does not impact effective choice, and it does not alter the driver of the advice.

- **Force advisors to itemise services against which transaction remuneration can be offset**: as discussed, the value of the transaction, the major component of this service process, is questionable under the current business model. Allowing advisors to write off commission against services which, for many, are either incidental to or there to induce transactions, is not going to change the value equation for the investor. It may pull the wool over many an eye though!

  Allowing advisors to charge for genuine advice led service processes is another thing entirely, and is something which would become viable if transaction remuneration was taken out of the equation.

- **Cap fees and/or costs:** this could negatively impact a business model that already exists solely to generate transactions and would fail to generate necessary improvement in standards and market competition needed to protect investors.

- **Ban transaction remuneration**: the arguments for which are well known and supported by this submission.

It has been my contention for some time that regulators in Canada are looking to bolster regulation of the transaction based service model as opposed to promoting and regulating advice led service processes which would require a change in industry focus and structure and an overhaul of regulation. This means retaining current suitability standards and investor responsibility. Disclosure and education, aimed at bolstering investor responsibility for the transaction, appear to be the main tools of tighter transaction based regulation.

There is, in my opinion, a general failure by regulators to fully appreciate and acknowledge the importance of good advice and the extent to which investors must necessarily rely on their advisors. The market place has been allowed to make "advice based service representations" that imply fiduciary type best interests standards while taking advantage of minimum standards regulation to avoid the responsibilities and obligations of such.

The only option capable of leading to fair outcomes for the consumer is one which removes transaction based remuneration from financial services products. But, if you remove the transaction remuneration, you are left with an advice based foundation for which current regulation and standards are ill equipped to deliver.

It took about 7 years, from start to finish, to develop, prepare for and implement the UK's Retail Distribution Review. Right from the start the UK regulator was clear about the issues, objectives and many of the solutions. Yet, the CSA has still to determine if there are any investor protection issues, let alone deliver the necessary moment of clarity and objectivity required to initiate a process of change.

Kind regards

Yours sincerely

Andrew Teasdale, BA Honours Economics, CFA