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Via Email

British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Office of the Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
Superintendent of Securities, Nunavut

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Dear Sirs and Mesdames:

RE: CSA Request for Comments on 81-407 Mutual Fund Fees

Thank you for the opportunity to comment on Mutual Fund Fees and suggested initiatives. I have a practice in the mediation of investment and financial disputes and in the appraisal of investment complaints prior to litigation. All my comments are based on the research presented in the Discussion Paper, my work in investigating or overseeing the resolution of over eighty complaints with Ombudsmen/Compliance offices and my personal opinion.

The issues to investors with respect to mutual fund fees are:
1. Are mutual fund fees reasonable or excessive?
2. Do investors understand what mutual fund fees they are paying or the purpose of the fees?
3. Are investors receiving value for the fees they are paying?

It is reasonable that fees should be charged, and paid, for good financial advice. What amount of fees is reasonable? The Discussion Paper does not deal with whether the fees charged by the Canadian mutual fund industry are reasonable or excessive. As a result of recent litigation in the U.S. concerning excessive mutual fund fees, (for example, Jones v Harris Associates L.P., March 2010) there has been some U.S. research on whether fees in the U.S. market are or are not excessive (The Mutual Fund Industry: Competition and Investor Welfare, R. Glenn Hubbard, Michael F. Koehn, Stanley I. Ornstein, Marc Van Audenrode, and Jimmy Royer, Columbia University Press, 2010,http://cup.columbia.edu/book/978-0-231-15182-5/). I do not know of similar studies in Canada. This could be an area of further study or investigation.

What the Discussion Paper does address, and is important for the industry to consider, is whether consumers understand the costs associated with investing in mutual funds and if understood, whether investors will agree that they are receiving value relative to the costs they are paying, both direct and indirect. The questions of the cost of mutual funds and whether value is being delivered, has become a growing issue among investors. On page 2 of the Discussion Paper, it is noted that in Canada, "mutual funds are the most commonly held investment product with 62% of Canadians with savings or investments set aside holding this product in their investment portfolios". However, with increasing availability of lower cost alternatives such as ETFs, a growing awareness of the actual cost of mutual funds, and the impact of mutual fund fees on retirement portfolios returns, the industry should be concerned about whether the perception of value can be sustained and whether a significant percentage of Canadians will continue to include mutual funds in their investment portfolios.

I would like to briefly comment on three of the areas identified in the Discussion Paper as areas of concern arising from the current mutual fund fee structure in Canada and comment on a proposed solution.

1. Investor's lack of understanding of and control over fees

The 2011 OBSI Annual Report indicated that 11% of 453 complaints made over that year were about "fees". Mutual fund vehicles are complex and layered securities. The fee structure is equally complex and for the average investor, very hard to make sense of. There are a variety of alternative direct fees or sales charges and a variety of "ongoing fund fees" including Trading Expenses and Management Expenses (which include the costs of marketing, administration, portfolio advice, promotion, management, financing and distribution, the latter cost also known as "trailing commissions"). Many investors do not understand how the Management Expenses (or when expressed as a percentage of the fund's average annual assets, the "MER") affects their returns. Most investors are not aware of the financing and distribution cost components in the MER. They do not understand that a percentage of the MER is paid in part to their dealer and advisor for ongoing investment advice, that this fee is paid regardless of the amount or quality of advice the investor receives, and that the percentage amount can be changed without prior notice or consent.

With respect to direct fees, as with any product, investors want to pay the lowest fee or no fee which makes a DSC load attractive. In conversations with investors in complaint interviews, most investors say that they only became aware they had purchased a mutual fund with a DSC load when they decided to sell the fund and ended up paying a fee. Even if they were aware, they did not understand that a commission was paid indirectly through the MER and that all investors were paying for the financing of that commission.

As indicated in the CSA Discussion Paper, investors are reluctant to ask their advisor about the costs of investing in mutual funds for many reasons. As well, most do not look at the prospectus disclosure because it is provided after their investment is made. In most of the complaint cases involving mutual funds, clients advised that they felt it unfair they received only selective disclosure prior to the purchase and were not told they had to read the prospectus after the purchase to obtain full details.

In many instances it is typical for investors to rely on only two sources for information; their statements and their advisor. In investigative complaint interviews, investors would typically say to me that the only information they reviewed was their statements. Unfortunately client statements do not reflect the indirect commissions being paid to the advisor or the impact of those fees on returns.

While advisors and firms have increasingly included disclosure of direct fees in their sales process, it appears that many advisors do not specifically disclose to their clients, the indirect cost of investing in mutual funds but instead rely on the disclosure provided in the mutual fund company's prospectus and in the Fund Facts. In most instances the advisor does not explain the implication of these charges or fees. Some clients complain that they were told by advisors that they would not pay any fees and did not understand until well into the complaint process that they were in fact paying fees not directly, but out of fund assets, and as such, through lower returns.

Even better and earlier disclosure is not sufficient to assist the investor in making an informed investment decision due to the complexity of the existing fee structure. Similarly better disclosure does not address the issue of investor's lack of control over their costs of investing.

While improving financial literacy among retail clients would be helpful, it is unrealistic to expect that financial literacy will be improved to the point where the majority of investors will have the wherewithal, or the time, to survey the mutual funds available and evaluate associated alternative fee structures, to ensure they are buying the lowest cost or best value investment. Investors and advisors would benefit from investors having to pay fees directly. This would allow investors to clearly understand the fees and to have some control over the costs they are paying.

2. Conflicts of Interest

It seems apparent that the current fee structure presents inherent conflicts of interest. Compensation drives behavior. If certain products generate higher trailing commissions, then regardless of "suitability" or market conditions, advisors are more likely to recommend those products. Accordingly, fund managers will pay higher trailing commissions on products they want the advisors to sell. This is really no different from a consumer goods company paying its retailer for better shelf space or a mortgage originator paying its salesman for an increased volume of assets (not quality of assets).

Potential inherent conflicts are often addressed through the imposition of fiduciary obligations. In other cases conflict of interest is avoided by having alternative compensation structures. In the investment industry, not all advisors have a fiduciary standard or "best interest" duty to clients. While imposing a "best duty standard" may be a good idea for the industry for a variety of reasons, the best duty standard is not a solution to the flaws that exist with an embedded fee structure. It is better to get rid of the conflict (by changing the fee structure), than to let the conflict continue and try to manage it through another mechanism (a best duty standard).

3. Lack of Alignment between Advisor Compensation and Services

According to the Discussion Paper, "trailing commissions were originally intended to compensate the dealer firms for the ongoing services their advisors provide to investors after the mutual fund purchase". However, the paper goes on to say there is limited evidence of any correlation between the amount of the trailing commission and the level of service the advisor provides. The extreme of this example is found in the Do-it Yourself (DIY) investor who is sold funds that include the trailing commission but who receives no on-going advice.

Clearly if the intention of the fee is to compensate advisors for ongoing financial advice, that payment should be made directly by the investor who is receiving the ongoing financial advice and can assess what level of financial advice they want to receive and whether they are receiving value for the fee they pay. If the ongoing fee is a distribution cost or sales commission, then it should be acknowledged as such and the fee should be eliminated, if there is no sales person involved.

Comment on the CSA Initiatives

As stated in the Discussion Paper, the suggested initiatives may affect stakeholders differently. From an investor's perspective, the initiatives may each have merit but the best solution to address the problems inherent in the payment of trailing commissions is to eliminate them. I recommend that the proposal to "discontinue the practice of advisor compensation being set by mutual fund manufacturers" be implemented. Instead of the current fees and charges, a simple and transparent flat fee would be negotiated between the advisor and client for the sale and ongoing servicing of the mutual fund investments. While this will represent a significant change to the industry, I recommend this initiative as it should:

1. reduce the disclosure burden on the mutual fund manufacturer;
2. lead to a simplified fee structure that an average investor can understand;
3. make the comparison of alternative securities easier for an investor to evaluate;
4. allow the industry to align compensation and service (or financial advice) with respect to all investors including DIY investors;
5. enable investors to have some control over what they pay for ongoing financial advice; (Agreements will have to be negotiated between investors and advisors as to the level of service desired and the associated cost.)
6. significantly mitigate conflicts of interest;
7. allow investors to see exactly what they are paying for in financial advice and allow advisors to draw a clear connection between their compensation and the value added service they provide; and
8. encourage competition among mutual fund manufacturers based on performance.

Yours truly,

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