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June 2, 2017

Re: CSA Consultation Paper 81-408 Consultation on the Option of Discontinuing Embedded Commissions

The Emerging Managers' Board is grateful to the CSA for the opportunity to provide comments on Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions.

Executive Summary

The Emerging Managers' Board is strongly supportive of the proposal to discontinue embedded commissions. We believe the measures should be implemented as quickly as possible. However, we strongly object to the 'mitigation measures' proposed by the CSA. We believe these proposed measures are actually worse than the existing embedded commission system. These mitigation measures replace one form of "bank tax" with another "tax" that is less efficient to administer and results in a worse outcome for fund manufacturers and the investing public.

Introduction to the Emerging Managers' Board

Background: The Emerging Managers' Board or EMB is a non-profit organization whose mission is to promote and contribute to the growth of Canadian emerging managers. It strives to educate asset allocators and investors about the benefits of investing with local talent. We have approximately 120 member firms in Quebec and Ontario, who are primarily independent manufacturers of investment funds. The AUM of the majority of our firm members is below $1 billion.

Confidentiality: All members of the Emerging Manager Board are regulated by a CSA member. As well, their business operations depend critically on broker/dealers for the custodial services, prime brokerage activities and access to their investment platforms for marketing their funds. In order to be able to express our views without fear of repercussions in their businesses, the authors of these comments have requested to remain anonymous.

Responses of the Emerging Managers' Board to Specific Questions

Question 2. *Are there other significant issues or harms related to embedded commissions? Please provide data to support your argument where possible.*

Response of the Emerging Managers' Board: Embedded commissions effectively function as a tax, one that is imposed by brokerages and dealers to pay for access to their platforms. There should be no pretence that the level of embedded fees is justifiable in relation to the amount of due diligence conducted by an Investment Advisor. Fund manufacturers are forced to give up 50% of their management fees (in most cases, their only source of fees) for the privilege of access to a dealer's investment platform. The existence of this *de facto* tax continues to stifle the development of an independent asset management industry and reduce competition, to the detriment of both Canadian investors and firms – particularly newer ones – looking to raise capital. The fact that Canada has one of the highest cost investment fund structures in the world is testament to the negative effects of embedded commissions. The elimination of embedded commissions will promote fair and more efficient operations in Canada's capital markets.

Question 4. *For each of the following investment products, whether sold under a prospectus or in the exempt market under a prospectus exemption: mutual fund, non-redeemable investment fund, or structured note, should the product be subject to the discontinuation of embedded commissions? If not, what would be the policy rationale for excluding it? What would be the risk of regulatory arbitrage occurring in the exempt market if embedded commissions were discontinued for the product only when sold under prospectus?*

Response of the Emerging Managers' Board: To avoid regulatory arbitrage between the Exempt and Prospectus markets or between different types of investment funds, there should be no exclusions from a discontinuation of embedded commissions. Further, all types of embedded fees should be included within this ban.

Question 5. *Are there specific types of mutual funds, non-redeemable investment funds or structured notes that should not be subject to the discontinuation of embedded commissions? Why?*

and

Question 6. *Are there other types of investment products that should be subject to the discontinuation of embedded commissions? Why?*

Response of the Emerging Managers' Board: We are not aware of other investment products that have embedded commissions; however, our conclusions would not change: all investment funds should be subject to discontinuation of embedded commissions.

Question 7. *Do you agree with the discontinuation of all payments made by persons or companies other than the investor in connection with the purchase or continued ownership of an investment fund security or structured note? Why or why not?*

Response of the Emerging Managers' Board: Yes, we agree. Again, all investment funds should be subject to discontinuation of embedded commissions.

Question 8. *Are there other fees or payments that we should consider discontinuing in connection with the purchase or continued ownership of an investment fund security or structured note, including:*

a. the payment of money and the provision of non-monetary benefits by investment fund managers to dealers and representatives in connection with marketing and educational practices under Part 5 of NI 81-105;
b. referral fees; and BUT won't banning referral fees hurt consumers by removing incentives for intermediaries to forward clients onto other intermediaries for their subject matter expertise or access to particular products?
c. underwriting commissions. BUT won't banning underwriting commissions especially hurt start-ups and hinder consumer access to securities?

Why? What is the risk and magnitude of regulatory arbitrage through these types of fees and commissions?

Response of the Emerging Managers' Board: Yes. All embedded fee structures should be subject to discontinuation, including underwriting fees and referral fees especially in the distribution of related entity fund products. Entities that have internal distribution channels (i.e. major bank-owned retail dealers), should not be able to charge underwriting commissions, a significant conflict of interest, while systematically restricting the distribution of non-related entity fund products from their retail platforms. Concurrent with the discontinuation of embedded commissions, attention must be given to the use of non-monetary benefits, as these benefits will become more prominent.

Question 10 a. *With respect to internal transfer payments: a. How effective is NI 81-105 in regulating payments within integrated financial service providers such that there is a level playing field for proprietary funds and third party funds?*

Response of the Emerging Managers' Board: Clearly NI 85-105 is not effective. Canada has one of the most concentrated asset management and one of the most concentrated brokerage sectors in the world, resulting in wide-spread conflicts of interest. This conflict is exacerbated by the systematic practice of limiting third party managed funds to the retail networks of the large integrated financial services providers. Investors' choices are unquestioningly reduced with limited means of redressing the uneven playing field between internal proprietary funds and third party funds.

Question 10 b. *Should internal transfer payments to dealers within integrated financial service providers that are tied to an investor's purchase or continued ownership of an investment fund security or structured note be discontinued? Why or why not? To what extent do integrated financial service providers directly or indirectly provide internal transfer payments to their affiliated dealers and their representatives to incent the distribution of their products?*

Response of the Emerging Managers' Board: Internal transfer payments should also be discontinued. Internal fund managers, brokers, and other financial planners are regularly pressured to purchase related party products. Tactics employed include: moral suasion, grid payout discrimination, minimum asset requirements for types of services, etc. Eliminating internal transfer payments within integrated financial

service providers will unquestionably reduce conflicts of interest and allow internal fund managers and brokers to actually act in the clients' best interests.

Question 11. *If we were to discontinue embedded commissions, please comment on whether we should allow investment fund managers or structured note issuers to facilitate investors' payment of dealer compensation by collecting it from the investor's investment and remitting it to the dealer on the investor's behalf.*

Response of the Emerging Managers' Board: Absolutely not. We strongly object to the 'mitigation measures' proposed by the CSA. As we noted at the outset, we believe these proposed measures are actually worse than the existing embedded commission system. These mitigation measures replace one form of 'bank tax' with another 'tax' that imposes higher operating costs on the administrator which is ultimately passed on to investors. Neither investors nor independent fund manufacturers will have any bargaining power in whether to adopt this practice or not. We will simply end up substituting embedded commission fees with an administratively less efficient 'tax' of similar magnitude. Investors will be no better off.

Question 15. *What effect do you think the removal of embedded commissions will have on investor experience and outcomes? In particular: What effect will the proposal have on the growth of the online/discount brokerage channel and cost of fund products offered in this channel? Is this likely to be beneficial to investors?*

Response of the Emerging Managers' Board: Removal of embedded commissions will result in lower fees, greater investment product choice, reduced conflicts of interest and an opportunity for new asset manager entrants to contemplate creating a business and; thereafter, potentially thrive. An example of the resulting lower fees is in respect of the full service charges that are imposed on DIY investors. According to the Embedded Commission Consultation Paper 81-408, $25 billion of $30 billion held by DIY mutual fund investors are 'sold' full trading commission fund series, so "many DIY mutual fund investors [in the online / discount brokerage channel] . . .indirectly pay for services they do not receive." [1] These DIY investors do not do so by choice. They simply acquiesce to the terms on offer, since all bargaining power lies with their brokerage. If a DIY investor wishes to purchase a fund on a broker platform, the choice is between buying the full commission series or not investing in that fund. Effectively, this is a transfer of wealth from the fund manufacturer to the broker / dealer for no services provided nor advice given; ultimately subsidized by the DIY investor. At the industry standard 1% embedded commission rate, this is a $250 million annual transfer from investors and fund manufacturers to the owners of online / discount brokerages. By eliminating embedded commissions, the revenue of most independent fund manufacturers will effectively double. It will make the fund management industry more competitive at the distribution level and provide investors with greater choice. Investors will clearly benefit from a more competitive fund management industry. In many areas of commercial activity which involve a large, sophisticated organization and a single individual, the harmful consequences of this asymmetry in bargaining power would be addressed by regulatory means. This is what we propose.

[1] CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commission, January 10, 2017, page 41

Question 18. *Given some of the changes we have seen in the industry over the past few years (fee reductions, introduction of DIY series, streamlining of fund series, automatic fee reductions increasing access to fee-based options etc.), what is the likelihood that the fund industry will transition away from embedded commissions without regulatory action?*

Response of the Emerging Managers' Board: We see no chance whatsoever that the embedded commissions model will simply wither away on its own. Due to the presence of their existing sales forces – both "captive" or in-house and independent advisors or representatives – existing distributors have a powerful incentive to continue the commission model. In the absence of an economic imperative, only regulatory action will work.

Question 20. *We note that the distribution of fee-based series is still relatively limited in Canada versus other markets. Are there obstacles (structural, operational, regulatory, investor demand, etc.) specific to Canada limiting the use of fee-based series by dealers?*

and

Question 21. *Please describe how discontinuing embedded commissions will affect competition and market structure and whether you agree with the analysis set out in Part 4?*

Response of the Emerging Managers' Board: Canada has one of the most concentrated asset management sectors in the world as well as one of the most concentrated brokerage sectors. Non-monetary incentives and moral suasion are powerful tools used by integrated parties to promote other purchase options over fee-based series. Embedded commissions are effectively a transfer of wealth from the fund manufacturer to owner of a broker platform. By eliminating embedded commissions, the revenue of most independent fund manufacturers will effectively double. It will make the fund management industry more competitive and provide investors with greater choice. Investors will clearly benefit from a more competitive fund management industry and industry concentration should improve. The discontinuation of embedded commissions will undoubtedly lead to new, lower-cost entrants to the market, as a significant barrier to entry will have been eliminated.

To be clear, full adoption of the fee-based series is not a solution in itself. Without rigorous and meaningful conflict of interest guidelines, brokers will explicitly and implicitly promote internal related products over third party investment products.

Question 22. *What impact will the proposal have on back office service processes at the investment fund manager or at the fund dealer? In particular: Is there any specific operational or technological impact that we should take into consideration?*

and

Question 27. *How practicable are the mitigation measures discussed and how effective would these measures be at assuring: choice of payment arrangements for all investor segments, and a level playing field amongst competing investment products?*

and

Question 29. *Other than the potential impacts we have identified in Part 4, what other potential unintended consequences, including operational impacts and tax consequences, may arise for fund industry stakeholders and investors further to the discontinuation of embedded commissions? In particular: would there be a negative tax impact to investors associated with their payment of dealer compensation under direct pay arrangements? In particular, would the investor's payment of dealer compensation through periodic fund redemptions facilitated by the investment fund manager attract tax consequences? Please explain.*

and

Question 32. *For each transition option, please tell us how your business (investment fund manager or dealer) would have to operationally change or restructure in terms of systems and processes and the related cost implications.*

Response of the Emerging Managers' Board: We strongly object to the 'mitigation measures' proposed by the CSA, namely the proposal to "allow investment fund managers or structured note issuers to facilitate investors' payment of dealer compensation by collecting it from the investor's investment and remitting it to the dealer on the investor's behalf." Effectively, each month, an Investment Fund Manager will have to redeem a portion of each fund for every unitholder and remit these tiny amounts to their unitholders' Investment Advisors. Redemptions remain a manual process. The back offices of Administrators and Investment Fund Managers are not designed to deal with huge numbers of tiny transactions. The imposition of such "mitigation measures" will serve as yet another barrier to entry for small independent fund manufacturers and increase the operational costs of these Investment Fund Managers solely for the benefit of Investment Advisors.

Further, investors would be subject to taxation on any such redemption. Both investors and Investment Fund Managers are better off under the current embedded commission system than under the CSA's proposal. The proposed measures will serve to further tilt the playing field against smaller independent Investment Fund Managers and fund manufacturers.