June 12, 2017

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

comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

Re: Canadian Securities Administrators Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions

HSBC, Retail Banking and Wealth Management (collectively, **HSBC** or **we**) are writing in response to the Request for Comment on the Consultation on the Option of Discontinuing Embedded Commissions published by the Canadian Securities Administrators (the **CSA**) on January 10, 2017 (the **Proposal**).

HSBC is one of the leading asset managers in Canada. Our investment management services include the offering conventional public mutual funds to the Canadian public (the **HSBC Funds**). HSBC Investment Funds (Canada) Inc. (**HIFC**) acts as the Principal Distributor for the HSBC Funds that are available for direct purchase. Except for the HSBC Funds, HIFC does not distribute or offer for sale any other investment funds or structured products. The HSBC Funds include a wide range of money market, fixed income, equity and balanced mutual funds, and include mutual funds which invest in a diversified mix of HSBC Funds. HSBC Global Asset Management (Canada) Limited (**AMCA**) acts as the investment fund manager (**IFM**) and portfolio advisor for the HSBC Funds.

We would like to thank the CSA for the substantial amount of work and effort that went into the Proposal. We would also like to thank the CSA for the opportunity to provide our comments on the Proposal. We support the CSA's initiative to enhance investor protection by eliminating actual and perceived conflicts of interest related to the Canadian dealer compensation structure. We respectfully caution however, that *some* aspects of the Proposal, if implemented, may have unintended consequences that may harm Canadian investors and the Canadian wealth management industry as a whole. We view some of these aspects, as further detailed below, as being on the periphery of the core objectives of the Proposal. As such, we urge the CSA to take into consideration both the Canadian investing public and the various business structures that will be negatively impacted by the implementation of the Proposal.

Below are some general comments on the Proposal, followed by comments on some of the specific questions posed.

The Advice Gap

We are of the view that the elimination of the DSC sales option is consistent with the CSA's goal of enhancing investor protection in the Canadian marketplace. AMCA, much like numerous other IFMs in Canada, has discontinued the DSC sales option for the HSBC Funds in 2014 to eliminate any potential misselling and to enhance the overall investor experience.

We respectfully caution that an advice gap may be created if the Proposal, specifically the ban on trailing commissions, is implemented. We believe that an advice gap may develop due to a number of reasons, including (i) a fee-based account being more expensive to administer than a commission-based account; (ii) a direct pay commission model is likely to be unpopular among the Canadian investing public and may create different types of conflicts of interests among dealers and dealing representatives; and (iii) technology may not be used as widely as hoped by various investors, specifically those in the "mass-market" segment.

Added Costs for Fee-based Accounts

We respectfully ask the CSA to consider the fact that administering a fee-based account is more expensive than a commission-based account. Dealers that do not currently offer fee-based account options will be required to make significant investments in infrastructure (e.g. computer software and systems, account agreements etc.) to facilitate fee-based accounts, and such costs will likely be passed onto the end investor. In addition, if advisory fees will be paid by redeeming an investor's mutual fund holdings, additional redemption orders will have to be processed at the mutual fund level, as well as at the dealer level. This will increase the operational costs for both the fund and the dealer, and ultimately, the end investor. We note that these added costs are already factored into current business models in the industry given that fee-based accounts usually require a substantial minimum of investment (typically set at $100,000).

Should the industry lower the current minimum investment and offer fee-based advisory services to those investors in the mass-market segment, we anticipate that these added operational costs will result in various dealers introducing minimum annual account fees to recover some of the additional costs incurred to serve investors at the bottom range of the mass market segment. As an example, an investor with $5,000 invested in a mutual fund that currently pays a 1% annual trailing commission who will be moved to a fee-based account may be subject to an account fee of 1% of assets, or $125 (whichever is greater). As a result, the total annual fee the noted investor will pay for advice will increase by $75, or 150%. We also note that the lack of mass-market investor access to fee-based accounts was also articulated in the recent MFDA research paper which stated that such clients are "less likely to be able to afford direct pay arrangements and less likely to be eligible for fee-based programs…"[1]

Finally, the Proposal refers to the fact over 80% of Canadian investors in the mass-market segment purchase their investment funds through banks or insurers. However, this distribution channel is likely to experience the same added cost when administering fee-based accounts that include non-proprietary mutual funds, potentially requiring such dealers to instill a similar minimum annual fee. Alternatively, this distribution channel may only offer proprietary mutual funds, thereby offering investors less choice.

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[1] *MFDA Bulletin #0721-C* (May 23, 2017), at page 11.

Direct Pay Commission Model
We respectfully submit that a direct pay commission distribution model may not address the advice gap created by the banning of trailing commissions, nor will it result in the removal of conflicts of interest in the mutual fund distribution channel.

We are of the view that the Canadian investing public will likely not embrace a mutual fund distribution model that requires investors to pay per transaction. The MFDA reached a similar conclusion in the research paper referenced above when it noted that a certain segment of clients is "less likely to be able to afford direct pay arrangements".[2] We are also of the view that some investors will likely experience "sticker shock" given the move in industry over the last decade towards the DSC sales option, and more recently, towards the no load sales option. This unintended consequence may lead certain groups of investors to forgo investing in mutual funds which can impact their ability to adequately plan and save for retirement.

In addition, should the markets experience a positive return during the period soon after the investment is made, investors may experience lower total returns since they will have less money invested in the market as a result of having to pay the commission up-front.

Lastly, and perhaps most importantly given the stated objectives of the Proposal, due to the fact that dealers would only get paid per-transaction, such a distribution model creates an inherent conflict of interest to churn the portfolio excessively. There have been numerous enforcement cases in the IIROC distribution channel[3] that highlight the materiality of this type of conflict, both within discretionary and non-discretionary accounts. As such, we respectfully submit that it is not in the public interest for the CSA to create an environment where advice may be tainted by this conflict of interest.

Technological Innovations
We agree with the CSA that new dealer platforms will likely enter the market as the technological and regulatory landscape transforms. As a result of various efficiencies, such dealers may be able to offer a fee-based program at a cheaper rate and with a lower account minimum. We, much like the rest of the industry, made significant investments in technology to make our operations more efficient and enhance customer experience. Based on our experience, unlike day-to-day banking which has gained significant traction in the online space, many mutual fund investors prefer dealing with a human representative, in person. This is consistent with an international survey of 12,019 people (1,001 of which were Canadian) conducted by Ipsos MORI in 2017 which found that only 7% of Canadian respondents would likely trust robo-advisors to make their investment choices, and only 18% indicated that they feel robo-advisors are able to offer more accurate advice than their human counterparts.[4]

If the current mass-market distribution channel will no longer serve the segment at a price that those investors are willing to pay, the Proposal may force investors who prefer to make

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[2] *MFDA Bulletin #0721-C* (May 23, 2017), at page 11.
[3] See *Crandall* (Re), 2016 IIROC 18, *Matthews* (Re), 2014 IIROC 56 and *Darrigo* (Re), 2014, IIROC 48 as examples
[4] The survey was commissioned by HSBC Bank Plc, but was written independently of HSBC. See http://www.hsbc.com/trust-in-technology-report and http://www.google.ca/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=0ahUKEwjCgeCXk6_UAhWK7IMKHZx6COIQFggmMAA&url=http%3A%2F%2Fwww.about.hsbc.ca%2F~%2Fmedia%2Fcanada%2Fen%2Fnews-and-media%2F170524-trust-in-tech-news-release-en.pdf&usg=AFQjCNGgyec6cb1OIe_btvCnaf0kceS_qQ

their mutual fund investment decisions in person to adopt technology and use the new distribution models out of necessity (i.e. lack of affordability). This may lead to less advisor use, as fewer investors experience a positive advisory experience, and as a result, a reduction in the number of mutual fund investors in the mass market segment.

Internal Transfer Payments

The Proposal proposes to ban all internal transfer payments from affiliates to dealers within an integrated financial service providers that are directly tied to an investor's purchase or continued ownership of an investment fund security or structured note (**internal transfer payments**). The premise of this ban equates such payments to trailing commissions. We respectfully submit that this premise creates a false equivalence — while the quantum of money received by a dealer may be similar, the reasons for the payment and the conflict of interest are not. As further detailed below, in certain cases, such an equivalence creates unnecessary restrictions for Canadian market participants while not advancing any of the stated goals of the Proposal.

As previously noted, HIFC is the Principal Distributor for some of the HSBC Funds. HIFC does not distribute or sell any non-HSBC investment funds or structured notes. As such, HIFC, and any other mutual fund dealer within an integrated financial service provider that only sells mutual funds offered by a single IFM (**non-conflicted dealer**), is not subject to the same conflict of interest that a mutual fund dealer that distributes mutual funds of multiple IFMs (**conflicted dealer**) is.

In the section below, we will explain why the three issues identified by the CSA that the Proposal attempts to address are not applicable to internal transfer payments to non-conflicted dealers.

Issue 1 - Embedded commissions raise a conflict of interest that misalign the interests of IFMs, dealers and representatives with those of investors

Sub-Issue 1.1 – Internal IFM COI
The CSA used Professor Cumming's study to propose that embedded commissions give rise to a conflict of interests for IFMs as embedded commissions reduce the sensitivity of fund flows to risk-adjusted performance, thereby making IFMs less focused on increasing their AUM using the generation of performance and more focused on increasing their AUM by incentivizing dealers through the compensation offered (the **IFM COI**). Although we do not agree with this conclusion because IFMs have a regulatory obligation to act honestly, in good faith and in the best interests of their funds, we respectfully submit that the IFM COI does not exist in respect of internal transfer payments to non-conflicted dealers. Given the captive nature of a non-conflicted dealer (i.e. the dealer can only sell mutual funds of the affiliated IFM), IFMs do not need to incentivize the sale of their funds by increasing the quantum of the internal transfer payments (this argument is further supported by the Profit Consolidation, as defined below). As a result, fund flows for such IFMs are not sensitive at all to the quantum of the internal transfer payments and the IFM COI does not exist.

Sub-Issue 1.2 – IFM Selection COI
A key underlying premise of Issue 1 is that a mutual fund representative *may* recommend one mutual fund over another as a result of a higher dealer compensation paid by the IFM (the **IFM Selection COI**). We assume this premise to be true for the purposes of our submissions.

The IFM Selection COI does not exist within a non-conflicted dealer. A non-conflicted dealer can only sell mutual funds from a single IFM and as such, the different levels of dealer compensation offered by different IFMs have no impact on its investment recommendations.

Sub-Issue 1.3 – Product Selection COI

An argument can be made that non-conflicted dealers may have an incentive to sell mutual funds or other bank products that pay the highest level of internal transfer payments (the **Product Selection COI**). As will be demonstrated below, such conflicts do not actually exist and any perceived conflict is mitigated by the current regulatory regime and internal procedures.

A non-conflicted dealer, by definition, is part of an integrated financial service provider. As such, any profits made by it, regardless of the product sold, will simply be consolidated at the controlling entity level. The same consolidation occurs with the profits made by the other business divisions of the entity, including the IFM member (the **Profit Consolidation**). As such, it can be said that irrespective of how you "slice the pie", the size of the pie for the controlling entity is the same.

Given the Profit Consolidation and the Product Selection COI, one may conclude that the non-conflicted dealer may still be incentivized to sell one product over another, irrespective of client interests. However, such a conclusion does not account for the suitability obligations of the dealer (i.e. the dealer will not be able to sell an equity mutual fund, even if it results in a higher level of internal transfer payment, if it is not suitable). In addition, such a conclusion does not take into account what actually transpires once the internal transfer payment is received by the non-conflicted dealer. In the case of HIFC, any internal transfer payments received are not in its direct interest, as they are forwarded to the controlling entity, HSBC Bank Canada and do not result in any direct compensation for the HIFC sales representatives.

In addition to the suitability obligations at the dealer level and the fact that internal transfer payments do not translate to compensation at the individual HIFC sales representative level, HSBC Bank Canada has implemented a performance recognition program (the **Program**) that does not incentivize any of its sales representatives to sell higher management fee mutual funds or higher margin bank products. Specifically, the Program is product agnostic – compensation and recognition of staff are not tied to which product (e.g. mutual fund, personal loan, mortgage etc.) they sell, its profit to any HSBC entity, or its associated internal transfer payment (if any).

In summary, given the Profit Consolidation, certain internal controls and compensation structures and the regulatory obligations noted, the non-conflicted dealer and its sales representatives would be indifferent to the quantum of internal transfer payment received since both the amount received and the amount retained by the IFM get consolidated at the controlling entity level. The amount of the internal transfer payment becomes a zero-sum game on a consolidated basis – as the internal transfer payment gets larger, the IFM's retained earnings get smaller. As such, internal transfer payments do not result in a Product Selection COI, or any other conflict of interests that the Proposal attempts to address.

Issue 2 – Embedded commissions limit investor awareness, understanding and control of dealer compensation costs

We respectfully submit that internal transfer payments should be viewed as entity-level accounting issues, and accordingly are not relevant to any limitations on investors' awareness, understanding and control of dealer compensation costs. We further submit that investors are likely indifferent with respect to how the management fee paid to the IFM by an investment fund is allocated **internally** between an IFM and a non-conflicted dealer within integrated financial services providers. Further, as you are aware, CRM2 already requires the disclosure of the dollar amount of the internal transfer payment received by dealers, per account, as part of the annual report on charges and other compensation. However, we submit that unlike how this information can be used when dealing with a conflicted dealer (i.e. judging if the advice received warrants the payments), this information is of a different, and arguably lower, value to investors when dealing with a non-conflicted dealer as all fees paid, regardless of how they are allocated internally, are likely viewed as fees paid to the controlling entity (e.g. HSBC Bank Canada) as part of the cost of investing in the investment funds offered.

Issue 3 – Embedded commissions paid generally do not align with the services provided to investors

We respectfully submit that internal transfer payments are not meant to align with the services provided to investors, and rather, as we stated above, they are simply a part of the corporate accounting framework. Irrespective of how their quantum is calculated, we are of the view that investors would be indifferent towards them as they likely view the management fee that the HSBC Funds pay as a fee paid to the controlling entity (e.g. HSBC Bank Canada), irrespective of how the fee is subsequently allocated internally.

To summarize our submissions on internal transfer payments, we are of the view that such payments should not be prohibited for non-conflicted dealers. We are of the view that such a ban would not address any of the issues that are identified by the CSA in the Proposal while restricting various accounting practices of integrated financial service providers without a conclusive benefit to investors. We understand that it may be tempting to group "trailer-like" payments, such as internal transfer payments, together with "embedded compensation", but urge the CSA to consider the nuances and the differences of such payments when compared to trailing commissions vis-a-vie the stated objectives of the Proposal.

Specific Questions

17. Do you think this proposal will lead to an advice gap? In particular:

- *Which segments of the market are likely to be affected? Please consider segmentation by wealth, geography (size and location of community e.g. remote, small, medium, large), age, technological sophistication, the level of fund ownership across households, etc.*
- *Do you agree with our definition of an advice gap?*
- *Should we differentiate between an advice gap for face-to-face advice and an advice gap generally?*
- *What types of advice or services currently provided today would be most affected by the proposal?*
- *Are there any potential interactions between this proposal, existing reforms such as CRM2 and other potential reforms such as CSA CP 33-404 that may affect the size of any potential advice gap?*
- *How could a potential advice gap, face-to-face advice gap or financial service gap be mitigated?*
- *Do you think that online advice could mitigate an advice gap? If so, how?*
- *Do you think that the significant market share of deposit-taker owned and insurer-owned dealers in fund distribution in Canada will affect the size or likelihood of an advice gap to develop?*

HSBC

As noted above under *"The Advice Gap"*, we are of the view that the Proposal may result in an advice gap for the lower end of the mass-market segment as account fee minimums will increase the total cost of advice and deter some investors from obtaining advice. With respect to direct commission arrangements, we respectfully submit that investors may find such arrangements uninviting and more importantly, respectfully submit that such arrangements create a conflict of interest whereby dealers are incentivized to excessively churn the portfolio. Lastly, based on our experience, we are of the view that any technological innovation that the CSA hopes will step in to fill the advice gap will face a segment of the Canadian population that today, appears to be reluctant to adapt and will forego mutual fund investing altogether. These unintended consequences may lead certain groups of investors to forgo investing in mutual funds which can impact their ability to adequately plan and save for retirement.

10. 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?

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?

c. Are there types of internal transfer payments that are not tied to an investor's purchase or continued ownership of an investment fund security or structured note that should be discontinued?

As noted above, we are of the view that internal transfer payments (as defined above) should not be discontinued for non-conflicted dealers (as defined above) as the fundamental issues that the Proposal addresses are simply not present within such arrangements. Such payments are based on internal accounting decisions and should be outside the scope of the Proposal and possibly, the mandate of the CSA. We respectfully submit that no investor protection or market efficiency concerns are triggered by these payments.

Thank you again for the opportunity to provide you with our comments. Please do not hesitate to contact me should you have any questions or wish to discuss our submissions.

Sincerely,

[redacted]

Larry Tomei
Executive Vice President and Head of
Retail Banking & Wealth Management
HSBC Bank Canada