COMMENTS REGARDING:
CSA CONSULTATION PAPER 81-408 – CONSULTATION ON THE OPTION OF DISCONTINUING ***EMBEDDED COMMISSIONS***

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Background

I am founder and Chief Financial Officer of an independent mutual fund dealer, Pewter Financial Ltd., which has operated continuously in Alberta since February, 1983. Our firm currently relies on embedded fees for approximately 95% of our revenue. As a very small dealer, we have adopted a low cost operating model which has allowed our firm to survive in spite of the costs of increased regulation. Due to the uncertain regulatory environment, we have not expanded the business since 1997 and have no plans to invest any additional resources into the retail mutual fund industry.

The comments that follow do not follow Appendix D – Summary of Consultation Questions, since I believe the issues raised below will not fit easily into the listed questions. Following the Socratic method of instruction, each of the following sections is followed by questions that securities regulators may wish to consider.

A. Tyranny vs. Freedom

The proposed action by the Canadian Securities Administrators ("CSA") to prohibit embedded commissions for mutual funds is at its most basic level the imposition of tyranny on residents of Canada. The proposal seeks to prohibit individuals of legal age ("the public") from making a contract that includes a provision for embedded commissions. Imposing the will of a dictatorial authority to limit the rights of individuals is tyranny. It matters not the intentions of the CSA to "protect" investors. A common theme amongst dictators was that their unilateral decision to take rights and freedoms away from citizens since this action was in the "best interests" of the population. The idea that Canadians do not have the capacity to make decisions and enter into contracts without the oversight of a supposedly benevolent regulator is both illogical and an affront to the principals of freedom and democracy upon which this country was founded. The CSA appears to believe that the public is incapable of making a private contract which includes embedded fee provisions, but the same public is entrusted with the responsibility of electing politicians that govern the country. These same elected politicians hire all securities regulators. Paradoxically, the CSA believes the public has the wisdom and sophistication to select the rulers that choose securities regulators but does not have the knowledge or ability to enter into private contracts that include embedded commissions.

Questions:

1. Does the reader believe that free and open societies are superior to closed authoritarian societies where citizens have limitations on their rights, including the right to freely make contracts (e.g. Canada vs. Venezuela)?
2. Does the reader wish to have their right to negotiate and agree to private contracts with other members of the society curtailed?

B. Tilting the Playing Field

The prohibition of embedded fees for mutual funds will favour entities that sell non-mutual fund products to the public. There are no other products in which the relevant regulators require that the retail/client contact person or entity has to be compensated separately from the other components of the product or service. For example, banks are not required to make a separate charge to customers for the costs of the bank employee that prepares the documentation involved with the customer purchasing a GIC. Life insurers are not required to prepare two invoices for their the customers, one for the charges of the life insurance agent retail services and another one for the all other charges grouped together (e.g. wholesale costs, administration costs, costs of the actual product, etc.). Embedded fees are used by virtually all industries, besides the financial service industry, that supply goods or services to the Canadian public. When selling an automobile, automobile dealers are not required to provide their customers with an invoice related to their services as retailers and another invoice that includes all non-retail components of the automobile (e.g. direct manufacturing costs, manufacturer administrative costs, marketing costs, etc.). Grocers are not required to identify the retail portion in the price of tomatoes. If the CSA insists that consumers are harmed when purchasing goods or services that include embedded fees, they should be lobbying for laws to ban embedded fees from all goods and services currently available in Canada. Targeting one area of the economy (financial services), and within that one industry area, one specific model of operations (independent retail mutual fund dealers) is not logical.

The imposition of this proposed regulatory overreach to ban embedded fees will diminish the ability of independent dealers to successfully compete against other product and service suppliers that are given free rein to design their own pricing/compensation policies. This policy will also further dissuade potential independent mutual fund dealers from entering the industry since it discriminates against one sector of the financial services industry (independent mutual fund dealers) and promotes another sector of the financial services industry (large entities that are both manufacturers and retailers of mutual funds).

Questions:

1. Why should the CSA be permitted to ban a specific compensation arrangement, when virtually all other goods and service providers are free to determine their own pricing/compensation model?
2. Does the reader believe all goods and service providers should be required by law to separate the retail and non-retail portion of the good or service when selling to the public?

C. Geographic Concentration of Financial Services Industry

The proposed policy will further concentrate the financial services industry in Toronto, Ontario by discouraging independent retail mutual fund dealers across the country. Rather than a widely dispersed industry that includes many small dealers that are independent from any one manufacturer, the proposal, through regulatory fiat, will unfairly support large financial institutions that have the ability and desire to both manufacture and retail their own mutual fund products. The concentration of all financial services in a limited number of large deposit taking institutions increases the risks to the financial system in Canada. This concentration of power can result in all the problems associated with the "too big to fail" philosophy, which places the risk of catastrophic failure of a large entity on the public, rather than with the shareholders and staff of the failing financial institution. The concentration of power and control of financial services in Toronto is detrimental to all other regions of the country, since decisions affecting non-Toronto regions are made by financial institutions based in Toronto. These decisions will likely be based on the best results for the Big Bank/OSC coalition. The current system of allowing local and regional retail independent mutual fund dealers to compete on a level playing field against the Toronto-based big banks results in a more stable financial system. Free competition amongst numerous suppliers provides the best results for the public, no matter what goods or service they are purchasing.

Questions:

1. Does the reader believe that limited competition that results from regulatory fiat is in the best interests of the public?
2. When making decisions regarding the purchase of any goods or services, does the reader prefer to have one choice or a wide variety of choices for the supply of the good or service?
3. Should the provision of virtually all financial services for Canada be controlled by institutions based in Toronto, Ontario?

D. Prohibition of Self Interest for Mutual Fund Dealers

CSA Staff Notice 81-327 includes the following statement (emphasis added):

We believe there is considerable scope for better aligning the interests of investment fund managers and dealers/representatives with those of the *investors they serve*.

The CSA appears to be under the misapprehension that the retail mutual fund industry exists to serve the interests of their clients. The CSA appears to believe that dealers are engaged in the industry as a charitable activity rather than as profit-seeking businesses. That independent mutual fund industry dealers exist to provide a "public good", to Canadians. In Canadian society, suppliers of other goods and services are not required to operate their businesses on a charitable basis. Large banks and other businesses exist to earn as much profit as possible for their shareholders. No one else operating a business is required by regulators to operate the business as a charity. According to the regulators, mutual fund dealers are required to "serve" the public, not operate profit generating businesses. Paradoxically, while regulators are permitted on an individual basis to operate from self-interest (e.g. by seeking the highest salary and benefits from their public regulator employers), the self-interest of mutual fund dealers is attacked. It appears that securities regulators are permitted to act in their personal self-interest, but those working in the retail mutual fund business exist to "serve". This approach is illogical. Securities regulators, large banks and independent mutual fund dealers and all Canadian businesses should all be permitted to act in their own self-interest (including the right to make private contracts), this is a fundamental tenant of a free and open society.

Questions:

1. Is it logical for the CSA to adopt the idea that one small specific segment (retail mutual fund dealers) of one sector of the economy (financial services) should be required to operate their business as a charity, while their direct competitors can operate as profit seeking businesses (e.g. banks, insurance companies, trust companies, etc.)?
2. Has the reader, if employed by the public sector, ever approached their supervisor and requested a reduction in the reader's salary, since such a reduction would "serve" the public interest by reducing the cost of the reader's salary to the public purse?
3. Why is the pursuit of self-interest acceptable for customers, regulators, banks, other businesses but not for independent mutual fund dealers?

E. Quest for Regulatory Perfection

The CSA appears to be searching for perfection in their design of a regulatory system. Rather than insuring that investors are informed of the nature of their proposed investment purchase (provision of a prospectus), the regulators have imposed an additional suitability standard. No other goods and services providers, to my knowledge, are required to meet a suitability standard test. For example, if a person wishes to purchase a home, the realtor is under no obligation to determine if the house chosen by the purchaser is "suitable" for their requirements. The Ontario Securities Commission ("OSC") is pursuing an even higher standard for dealers, the fiduciary standard. The fiduciary standard is virtually impossible for a profit-making business to meet, since businesses exist to earn profits not "serve" customers. Any profit earned by a business is unacceptable, since the business should have been returned any profit to the customer to fulfill their fiduciary duty.

Rather than seeking a perfect regulatory system, the CSA's goal should be to operate a regulatory system which supports the fundamental foundational concepts of a free society, including the unfettered right of the public to enter into contracts with each other.

Questions:

1. Is it logical for the CSA to attempt to design a regulatory system that seeks perfection as a realistic goal?
2. Does the CSA have any obligation to support the fundamental principles of a free society in the design and enforcement of its regulations?

CONCLUSION

In the past 20 years, the level of competition in the retail mutual fund industry has diminished. The number of dealers continues to decline due to the uncertain regulatory environment. Dealers are forced to operate in an industry where the basic tenets of logic and fundamental principles of a free society are ignored. No logical entrepreneur would invest resources in a business environment where the regulators have unchecked power and are proposing to use that power to favour a specific class of competitors (large banks) over independent dealers. As a result, the Canadian public is left with fewer and fewer choices to meet their financial service needs. Many Canadians want to establish relationships with large banks that are manufacturers and retailers of proprietary financial products. Others wish to form life-long relationships with independent financial service retailers that have access to a wide variety of financial products from competitive manufacturers. In a free and open society, the Canadian public should have the freedom to choose the financial service provider that best fulfills their needs. This freedom should also include the freedom to determine the amount and method of payment of the compensation that the financial service provider will receive.