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ILLUMINATING

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British Columbia Securities Commission
Alberta Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan
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

Attention:

The Secretary
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Me Anne-Marie Beaudoin
Corporate Secretary
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Re: CSA Consultation Paper 81-408: Consultation on the Option of Discontinuing Embedded Commissions

Dear CSA members**,**

We are writing to provide our comments on the Canadian Securities Administrators' ("CSA") *Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions*, published on January 10, 2017 (the "Consultation Paper").

At Sun Life Global Investments, we firmly believe all Canadians deserve access to financial advice. They also deserve to have a choice in how they pay for that advice based on personal preference and financial circumstance.

The embedded compensation model offers easy and affordable access to financial advice. It's especially effective for those with less money to invest.

We agree that embedded compensation has the potential to create conflicts of interest.

We do *not* think the potential for conflict of interest means embedded compensation should be banned.

The goal of this letter is to persuade the CSA to consider the following ideas for reform instead of banning embedded compensation:

- A service agreement and enhanced relationship disclosure between advisors and clients
- A standardized naming convention for different types of funds based on compensation structure
- A ban on distributing funds with embedded compensation through channels that do not offer advice
- Implementation of "CRM3" cost disclosure

We've set out primarily to address the third of the Consultation Paper's stated objectives, which is to "obtain feedback on alternative options that could sufficiently manage or mitigate the identified investor protection and market efficiency issues." Our proposals focus on investor protection and to a lesser extent, market efficiency.

Following the description of our proposals, we summarize our views on why we don't think it would be wise to ban embedded compensation. Here, we seek to contribute to the first of the CSA's stated objectives, which is to "assess the potential effects on investors and market participants of discontinuing embedded commissions."

While we acknowledge the CSA's concerns with embedded compensation, we believe the embedded compensation model has played a significant role in growing our country's financial wealth and health, and that it will continue to do so for decades to come.

ALTERNATIVES TO A BAN

We believe the concerns raised in the Consultation Paper can be addressed without banning embedded compensation. We propose these reforms as a means of continuing to give clients the choice of paying for advice through compensation built into the cost of financial products.

A service agreement and enhanced relationship disclosure between advisors and clients

Dealers should be required to enter into an agreement with each client that explains their compensation options (e.g., embedded and fee-based). The agreement would also state the services the client should expect to receive.

The advisor should be required to review with the client both embedded compensation and fee-based options for paying for advice and explain the advantages and disadvantages of each. The advisor would also describe the cost of advice and review the services the client can expect to receive.

The client and the advisor would sign the agreement to confirm the compensation option chosen by the client and the commitment from the dealer and advisor to provide the services. The advisor assigned to the client would then have the ongoing obligation to provide the agreed upon level of service.

The service agreement and the additional relationship disclosure would significantly enhance client awareness and understanding of compensation issues. It would put the client directly in control of the choice between fee-based and embedded compensation.

Clients could determine which compensation options and service packages are the most convenient and cost-effective for them. The service agreement would also give the client a clear basis for comparing the costs associated with different fund companies and the service options provided by other dealers. Empowering clients in this way will add to the market forces driving the industry toward market efficiency and value for clients.

The service agreement would give clients a clear commitment describing the services they will receive. It would make the dealer and the advisor accountable to deliver the agreed-upon services.

All of this will enhance the professionalism of advisors and increase public confidence in the industry.

A standardized naming convention for different types of funds based on compensation structure

Industry standards should be adopted for fund companies to identify if a fund or fund series is fee-based or has embedded compensation. This should be done in a way that clients can readily understand.

A ban on distributing funds with embedded compensation through channels that do not offer advice

It may seem like an obvious piece of investor protection, and yet currently, there don't appear to be adequate systems in place to prevent investors from buying funds that have the cost of advice embedded, even when the distribution channel doesn't allow the provision of advice. Series A mutual fund units, for example, should not be sold in channels where no advice is provided.

Implementation of "CRM3" cost disclosure

We support IFIC's announcement on April 25, 2017 regarding moving to "CRM3" cost disclosure. This would mean providing clients with clear information about the management expense ratio and its components. This will give clients a better understanding of the total cost of ownership of their investments. It will also enhance discussions between advisors and clients and give clients the additional information they need to better understand the compensation disclosure they receive under CRM2.

These reforms effectively address the CSA's three key concerns about embedded compensation:

- **Conflicts of interest** – Explicit relationship discussions focused on compensation options together with a service agreement that sets out those options will increase the visibility and client awareness of embedded compensation. This additional visibility will continue to put downward pressure on funds that have embedded compensation levels beyond industry norms, reducing the potential for conflicts of interest.
- **Awareness, understanding and control –** Taken together, the service agreement, the more detailed compensation discussions and the CRM3 cost disclosure, will significantly heighten client awareness and understanding of compensation costs. The standardized naming conventions will make it easier for clients to understand their options and assess the one that is right for them. Avoiding a ban gives clients more choice and control in how to pay for advice. Clients will continue to have a simple measure of the total cost of their investment that they can readily compare across other mutual funds.

- **Clients getting what they pay for** – The service agreement gives clients a clear and enforceable commitment that they will receive the service for which they are paying.

WHAT'S WRONG WITH A BAN?

We now turn to the reasons we don't believe a ban on embedded compensation is the best way to address the CSA's concerns. We recognize the CSA and other industry participants are likely familiar with the general arguments. Our point is simply to contextualize the proposals above by isolating what we believe are the most important reasons to maintain the embedded compensation model as a choice for investors.

The following key questions posed by the Consultation Paper are just some of those we seek to address with our comments:

- "Are there significant benefits to embedded commissions such as access to advice, efficiency and cost effectiveness of business models, and heightened competition that may outweigh the issues or harms of embedded commissions in some or all circumstances?"
- "Are there other ways in which the CSA could address these issues that could be introduced in conjunction with, or separate from, the discontinuation of embedded commissions?"
- "What effect do you think the removal of embedded commissions will have on investor experience and outcomes?"
- "Do you think this proposal will lead to an advice gap?"

1. Embedded compensation and conflict of interest

Dealers and advisors
The Consultation Paper argues that a ban is warranted because embedded compensation creates conflicts of interest for both fund companies and for dealers and their advisors. However, **the fact that the compensation is embedded doesn't create a conflict of interest. A conflict arises if, all other aspects of the two funds being equal, the embedded compensation for one fund is higher than another similar fund thereby providing an incentive for an advisor to recommend the fund with the higher compensation.** It is these

differences in compensation identified in the Cummings[1] and Brondesbury[2] reports that give rise to potential conflicts, and drive the concerns outlined in the Consultation Paper.

Research says that market forces have reduced embedded compensation levels in recent years. In 2016, across the industry, 94% of equity and balanced funds paid 100 basis points (bps) or less in trail compensation (in the previous year 90% of equity and balanced funds paid 100 bps or less in trail compensation).[3] With only a small percentage of funds paying more than 100 bps, compensation is less likely to influence product recommendations. In addition, many dealers manage their product shelves to avoid offering funds that provide compensation levels outside of industry norms.

Research from PricewaterhouseCoopers concluded that there is no significant evidence that embedded compensation leads to conflicts of interest that influence the behaviour of advisors.[4]

Fund managers

The Consultation Paper states that fund managers are more focused on attracting assets by paying high levels of compensation to dealers and advisors, than on strong performance for investors. It goes on to state that fund managers may have ceased even trying to outperform.

We disagree. The PricewaterhouseCoopers research found no evidence that compensation levels lead to suboptimal fund performance.[5] Fund flows and compensation levels say little or nothing about a fund manager's desire to perform.

Fund managers aggressively compete on performance for their clients and strive to win awards and recognition for strong performance. Fund managers take their fiduciary obligations and professional responsibilities very seriously. An increasing degree of alignment in compensation levels across fund companies[6] has developed in recent years. This is strong evidence that most fund companies aren't using compensation levels to incent advisors to attract flows.

Compensation that is above industry norms will necessarily reduce a fund's net investment performance and make the fund's performance less competitive. Advisors and clients are looking for the top performing funds. Funds with performance above the median attract a higher percentage of sales.

From its inception in 2010, SLGI's strategy has been to earn our clients' business by developing excellent products and establishing a strong record of performance, with downside protection as

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[1] Douglas Cummings, et al, "A Dissection of Mutual Funds Fees, Flows and Performance," October 19, 2015

[2] The Brondesbury Group, "Mutual Fund Fee Research," spring 2015

[3] Internal Analysis from the Investment Funds Institute of Canada.

[4] Pricewaterhouse Coopers, "Economic Impact Assessment of Banning Embedded Commissions in the Sales of Mutual Funds," June 2017, page iii

[5] PricewaterhouseCoopers, page 46

[6] See note 4 above

a core competency. From the outset, we have paid industry standard for embedded compensation. Compensation is not our focus and it has not been a factor in our success.

2. Many clients value the embedded compensation option

Many clients like having the cost of financial advice included in the cost of the financial products they buy. It gives them a simple, effective, and affordable option to pay for financial advice. It gives them a clear view of the total cost of their investments. We see no reason to take that option away. The total cost of owning a mutual fund, including the cost of advice, is less prominent and more difficult to determine in a fee-based model[7] because it requires the client to add the fund level costs reported by the fund company to the cost of advice and distribution provided in a separate report from their dealer.

A recent study by Ipsos-Reid concluded that:

> "The preferred method for being charged for financial advice is for it to be included in the purchase price of investment products."[8]

In that same study, 35% of clients preferred to have the cost of advice included in the cost of investment products they buy.[9] That was the most popular option among the survey respondents. In the 2016 Pollara survey, just over half (54%) said they would prefer to compensate their advisor through bundled fees, while 37% would prefer to pay a direct fee.[10] Clients should continue to have this option.

3. Issues with fee-based compensation

The Consultation Paper suggests that, in a fee-based compensation system, units could be redeemed from the client's account to pay the fees. While redeeming units at the fund level is a convenient way for clients to pay the fees that they have agreed to with their dealer, it will not work in all situations. This option is not available with many types of locked-in accounts and has negative tax implications for registered accounts such as RRSPs or RESPs. For these accounts, clients must pay fees to their dealer by direct payment like cheque or credit card or by redeeming other assets. This may be inconvenient for them and may create a financial burden.

Fee-based compensation likely has its own conflict of interest issues.[11] The Brondesbury report commissioned for the OSC notes:

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[7] Pierre Lortie, "A major setback for retirement savings: Changing how financial advisers are compensated could hurt less-than wealthy investors most," University of Calgary, SPP Research Papers, volume 9, Issue 13, April 2016. Pages 26-27, 29. See also PricewaterhouseCoopers, page 40

[8] Ipsos-Reid, "Canadians and Investment Advice, 2016" page 13

[9] Ipsos-Reid, page 13

[10] Pollara, 2016 "Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry," page 28

[11] PricewaterhouseCoopers, pages 46 and 47

> "While we know that commission has its biases, we also know that FB [fee-based compensation] likely creates some biases. These biases are not as well established as those for commission; but a few are strongly suspected (e.g., reverse churning, more sale of proprietary products). They require further study. …we need to know a lot more about the impact of FB compensation compared to commission, particularly in relation to amount of investable assets."[12]

Brondesbury also says that it is unclear whether the fee-based model will improve outcomes for clients:

> "But while removing commission lowers product cost, advisory fees rise as a means of paying for the cost of service. There may also be new or increased administrative fees, higher costs on margin accounts and lower payments on cash balances. Based on available evidence about fee increases, it is not yet clear whether moving from commission to fees will result in a net improvement in the overall return to the investor, although it is likely that lower cost products will outperform those bought under a commission-based regime, given the negative impact of expenses on investment returns."[13]

> "The impact of fee-based compensation has not been sufficiently studied yet."[14]

A ban may not eliminate conflicts of interest. Since it isn't clear that clients will be better off in a fee-based model, they should continue to have the option to choose the embedded compensation model.

4. The value of advice

SLGI believes in the value of professional financial advice. The vast majority of advisors are committed, qualified professionals who are dedicated to serving the interests of their clients. The Consultation Paper questions whether clients are getting value for the embedded compensation they pay. The 2016 report by CIRANO demonstrates the value that advisors provide in wealth creation:

> "…the presence of a financial advisor proves its effect as soon as the first four years. The additional value reaches 290% for a household with an advisor for fifteen years or more: 3.9 times the value of assets of equivalent non-advised households."[15]

Advisors do a lot to add value for their clients. They help clients develop savings discipline. They support clients in rebalancing, budgeting, debt management, and planning for retirement.

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[12] The Brondesbury Group, "Mutual Fund Fee Research," spring 2015, page 42
[13] Brondesbury, pages 74-75
[14] Brondesbury, page 75
[15] Claude Montmarquette et al., "The Gamma Factor and the Value of Investment advice," CIRANO Institute, August 2016, page 41

Clients also see the advisor's role more broadly. In a recent study, "…fewer than half of clients believe investing services represent 30% or more of the value of an advisor."[16] Any policy development relating to the value of advice needs to reflect all aspects of the services advisors perform for their clients.

5. Access to advice

SLGI has many clients with smaller accounts. These clients in particular need professional advice to help them save adequately for retirement and invest effectively.

Embedded compensation provides these clients with an affordable way to get professional financial advice. It also helps to facilitate access to advice and overcomes the reluctance of many clients to pay directly for financial advice. Many clients prefer embedded compensation.[17]

Some clients are reluctant to pay for advice directly.[18] If embedded compensation is eliminated, we believe that many clients would decide not to invest at all. For others, the advice may become unaffordable.

The cost of advice will likely increase for clients with smaller accounts as the embedded compensation is no longer present as a constraint on fee-based pricing. Fees for smaller accounts will likely rise as dealers must set fee levels for smaller accounts to get sufficient revenue to cover their costs.

Dealers will also target clients with larger accounts and increase pricing on less profitable, smaller accounts.[19] Clients who want to invest may not be able to find a dealer to service them because their account balance is below higher minimum account thresholds set by the dealers.

> "People with less wealth and less income will find it harder to get advice for two reasons. First, it is difficult to generate sufficient income to cover costs, solely from sales of investments to this group. Second, in a fee-paying regime, there is evidence that they are less willing to pay fees to cover their cost of service."[20]

Embedded compensation bans have led to significant advice gap problems in other jurisdictions as dealers and advisors increase account minimums and focus on wealthy clients who are prepared to pay directly for advice.[21] Some jurisdictions decided against a ban because of concerns about an advice gap.[22]

6. Robo-advice and passive investments won't prevent an advice gap

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[16] Ipsos-Reid, "Canadians and Financial Advice, 2016" page 8
[17] Ipsos-Reid, "Canadians and Financial Advice, 2016" page 13
[18] Lortie, pages 18 and 19
[19] Lortie, page 21
[20] Brondesbury, page 76
[21] Lortie, pages 22 to 25, 34, 35
[22] Lortie, page 9. PricewaterhouseCoopers, pages 68-70

The Consultation Paper sees robo-advice and passively managed products as an answer to the risk of an advice gap. However, there is considerable evidence that many clients want face-to-face advice and are unlikely to use a robo-advisor.

- A recent Ipsos-Reid study found that client interest in Canada in using robo-advice is low – 18% of Canadians said they were likely (a rating of 6 or more on a 10 point scale) to use a robo-advisor (only 5% rated their likelihood 8 or more on a 10 point scale). Put another way 82% of Canadians said they were unlikely to use a robo-advisor.

- Of the clients who were interested in using a robo-advisor, most did not see it replacing their existing advisor.[23] The most common reasons for not using a robo-advisor were that clients wanted to interact with a person and valued face-to-face interaction with their advisor.

- Many elderly clients with small accounts will have limited knowledge of technology. They would have difficulty in accessing the services of a robo-advisor.

Clients with smaller accounts should continue to have choice in how they access financial advice, rather than being left with limited options that they don't want or value.

Additionally, clients with smaller accounts should be able to choose either passively or actively managed funds. On one hand, passive strategies are generally more cost-efficient and may outperform in strong markets, as has been the case more recently. On the other hand, active investment strategies, on average, have generated superior returns, after fees, over longer periods in a broad range of asset classes.[24] They have also, on average, generally produced a better reward relative to risk.[25]

Downside protection also plays an important role within the emotional dimension of investing. Looking beyond individual funds at the overall account level, research has found that "active investments produce superior investor returns over long time periods, while passive investments have better investor returns over shorter periods." This research attributes "active higher investor returns to the tendency of these investors to stay invested for longer periods."[26]

Passive investments essentially delegate the investment management function to the end investor. As opposed to evaluating a professional for their expertise and overall alignment, the investor is now tasked with evaluating markets. Clients with smaller accounts without personalized financial advice are unlikely to be well equipped to perform this function. In a passive strategy, clients are exposed to significant risk, especially during periods of market downturns and volatility.

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[23] Ipsos-Reid, pages 29 -32. A recent HSBC study had similar findings: HSBC, "Trust in Technology Report – Country Report/Canada," News Release, May 24 2017
[24] Internal SLGI analysis based on data from Morningstar Direct
[25] Internal SLGI analysis based on data from Morningstar Direct
[26] http://www.wealthmanagement.com/industry/does-active-produce-better-investor-behavior

CONCLUSION

Taken together, we believe the alternative reforms outlined above would effectively address the CSA's primary concerns about embedded compensation. Please consider our suggestions, particularly our recommendation for a service agreement and enhanced relationship disclosure between advisors and clients.

A ban on embedded compensation would risk leaving many clients without adequate access to personalized financial advice and without the support they need to save for retirement.

We urge the CSA to continue to give clients the choice of having their advice fees included in the cost of their financial products.

Thank you for the opportunity to participate in the consultation. I would be pleased to discuss any aspect of this letter with you.

Sincerely,

[redacted]

Rick Headrick

ABOUT SUN LIFE GLOBAL INVESTMENTS

Sun Life Global Investments offers Canadians a diverse lineup of mutual funds and innovative portfolio solutions, empowering them to pursue their financial goals at every life stage. We bring together the strength of one of Canada's most trusted names in financial services with some of the best asset managers from around the world to deliver a truly global investment platform. Sun Life Global Investments manages more than $18 billion on behalf of institutional and retail investors from coast to coast and is a member of the Sun Life Financial group of companies.