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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
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Dear Sir/Madame

Re CSA CONSULTATION PAPER 81-408 – CONSULTATION ON THE OPTION OF DISCONTINUING EMBEDDED COMMISSIONS

The consultation paper raises the three main investor protection and market efficiency concerns of Canada's securities regulators:

1. Embedded commissions raise conflicts of interest that misalign the interests of investment fund managers, dealers and representatives with those of investors;

2. Embedded commissions limit investor awareness, understanding and control of dealer compensation costs; and

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

With regard to point 1

The paper focuses on the presumption that embedded commission focuses fund management on sales relationships as opposed to performance and the impact of embedded commission on fund/security selection. I have no disagreement with these points and they are well backed up empirically and anecdotally.

But, the impact of transaction remuneration, embedded or otherwise, does in fact impact the advice process at a much deeper and earlier level, and this is something the paper fails to address. Investment advice should be driven by a process that incorporates a number of inputs: financial needs (size and timing), existing assets, future savings, risk profile, asset class/security risk return profiles and construction, planning and management disciplines. Transaction remuneration, whether embedded or not, and I include internal transfers, overrides the integrity of the advice process by focussing on the returns from transactions and hence advice can be swayed by sales imperatives. The product is not the process, but the output and needs to be treated as such.

A continuing and fundamental weakness of Canadian regulation of retail financial services is that it cannot adequately remove itself from the transaction frame through which it has regulated and assessed regulation. Investors are still assumed to be accessing advisors for product/security recommendations and it is the investor that is assumed to be knowingly retaining discretion over the investment decision and the frame in which those decisions are made.

The paper proposes changes that, in as far as they go, would better serve a best product standard. This is very much in keeping with the earlier consultation paper discussing best interest standards and targeted reforms. It appears from the paper that the CSA is favouring better definition and greater discipline in a key area of retail financial services that it considers to be focussed on product distribution and advice associated with product distribution. It should instead be focused on advice, irrespective of the product.

The removal of embedded commissions, in the limited form proposed (retention of internal transfers and other remuneration conflicts) without a supporting statutory best interest standard (with fiduciary roots) may well create some unstable dynamics in the industry itself.

With respect to point 2

Agreed, in the sense that investors need to know the costs and value of advice in order to decide whether they need and want the advice and to seek other services in the market place if necessary.

However I am not so sure that investors are going to gain the necessary insight into or be able to control dealer compensation costs by virtue of the proposed changes. Many of the dealer costs are costs related to the process of product distribution and not advice and suffer from the same problem as that noted in point 3.

The paper appears to assume that it will be consumers who, once aware of product costs, will initiate the competitive market dynamics that will force a) dealers to better align service costs with service value and b) fund management companies their fund costs with fund value/risk adjusted performance. I say this because the largest part of the market place is owned by vertically integrated bank/insurers with their proprietary business models. The necessary transparency at the proprietary level will not exist under the proposed regulations.

Again, the objective of addressing the issue noted is considerably weakened by a failure to implement a best interest standard (with a fiduciary root) for the provision of advice. Such a standard would focus service processes away from the product, to the provision of advice based service structures against which investors would be able to assess and better validate the costs and value of advice.

I would also point the implied reliance on disclosure by investors for the changes that are expected to follow from a removal of embedded remuneration. Disclosure is a notoriously weak medium in which to enforce consumer responsibility/cognition of the issues, especially with the considerable latitude available to weaken such disclosure. The proposals appear therefore to place the consumer at the heart of the issue, almost as if it is the consumer that is the principal cause of the weaknesses itself:

> "Investors should be provided with a compensation model that empowers them and that better aligns the interests of investment fund managers, dealers and representatives with those of investors."

Investors would be better placed to benefit from the changes if the industry was likewise exposed to the rigours of a proper best interest standard, and hence the proposed changes lack necessarily structural balance and integrity.

With respect to point 3

Embedded commissions do not generally align with services provided, agreed. But just what are the services being provided that the CSA are alluding to? It seems to me that the CSA are still referring to a system where the product/security is the focus of the service and advice is incidental but not all embracing.

One of the problems with commissions is that they focus endeavours on the transaction. In order to align fees with service you also need service processes that match the represented service itself.

Is the objective of the paper to provide a basis through which the costs of product servicing and advice can be better reflected by a so called payment agreement reached between client and advisor, or are we trying to focus remuneration on the fundamental processes underpinning personalised investment advice, the actual representation of service that has come to embody the industry?

The former is much simpler and quicker; the latter much more involved and requiring of much more demanding professional and regulatory standards and a longer period of transition. That the paper's proposals are only affecting the visible and direct embedded transaction remuneration, and not the indirect and invisible, suggests to me that the object of the current proposal is more to do with getting costs and values of product distribution better aligned.

The Consultation is correct when it questions the relationship between service and commission rates. But the primary reason why fixed commissions are an issue in terms of service specification is that they provide little or no incentive to develop processes that either meet more complex needs or the narrower scope and focus of simplified advice. The solution is not as simple as changing the way in which the transaction return is paid for but extends to the need to change service structure and service processes.

The Canadian Solution – reinforcing the bank/insurer product distribution model

> "our goal is to ensure that any regulatory action we may decide to take will provide *a Canadian solution* to challenges specific to the Canadian market , will result in more positive outcomes for Canadian investors and will *minimize disruption for market participants*"

The centrepiece of the consultation paper is the glaring exclusion of internal transfer payments from the proposed reforms.

The consultation, with its omission of cross subsidisation and internal transfers within larger bank/insurer owned, vertically integrated organisations, leaves quite significant conflicts of interest in situ.

The consultation provides no rationale as to why these internal transfers are still to be allowed. Yet, it expresses high level awareness of the risks of such retention; retaining internal transfers poses competitive market pressures on the very segments the consultation is depending on for the success of removal of embedded compensation. Pressure will be placed on independent dealers and fund managers and clients of the same, whereas the existence of what is effectively a transaction return "safe harbour", risks pushing more business into an overly concentrated, bank/insurer dominated, market place.

Is this the Canadian solution?

Does the CSA see no issue with internal transfers that are themselves dependent on sales targets within a product/security distribution model beset with conflicts of interest? The revelations unearthed by CBC GO Public's investigation of Canada's banks should give cause for some concern over the consultations strategic omissions.

Internal transfers – a failure to go beyond the point of sales

The only reason I can see for allowing internal transfers is the CSA's ostensible fixation on the product and its distribution.

The fact that an internal transfer payment cannot be traced directly to a purchase ignores the point.

Within an organisation that does not tie remuneration directly to a client's fund purchase, the view may be that there is no palpable incentive to recommend one product over the other. But within an internal transfer regime, remuneration comes from returns on products and product sales and hence the organisation is susceptible to impairment of advice from sales pressure and the fundamental focus on the product as the be all and end all of the service itself.

In order to fund these internal transfers the costs on many products and securities will be necessarily higher than they would be in a competitive market place. The CSA's 3 objectives are not met with respect investors processed through the proprietary model..

As the consultation states, the bank/insurer product distribution model is the dominant model and it is the model at the heart of retail conflicts of interest.

By exposing smaller independent firms of dealers and advisors and fund managers fully to the competitive dynamics of proposed changes and shielding the larger vertically integrated firms, there is a big risk that instead of stimulating competition, that competition is stifled and barriers to entry raised.

With most of MFDA'a/IIROC's firms' assets administered by bank/insurer owned dealers, there must be a tremendous incentive for firms to bypass the requirements of the targeted reforms and restrictions on payment of embedded commissions affecting the independent model. The risk is that current proposals will accentuate the move towards proprietary funds and to rely increasingly on internal transfers as a means of remunerating advisors. Where is the transparency and accountability?

Other issues

Up front commissions still allowed

I note that the consultation would still allow some form of up front commission payment as long as the payment itself is not embedded in a fund's/security's charging structure. I presume this will mean that such transactions could end up being like a share transaction with a statement showing units purchased and commission costs. This defeats one of the objectives of removing commissions from transactions, which is to focus remuneration on the advice as opposed to the transaction.

Referral fees

Referral fees are one of the most corrupting influences on objectivity. Within large vertically integrated organisations referral fees provide significant incentives to cross sell. Such fees override the analytical algorithms that should be dominant when making recommendations to clients. The cost of advice behind the referral should be covered within the advice relationship as opposed to being an additional cost to investors. In my experience referral fees direct business to whomever is willing to pay the most. Referral fees either increase costs or, where they depress margins, impact the time allotted to service processing. What are mutual fund embedded commissions if not a referral fee?

Dealer Commissions Paid out of underwriting commissions

Again, anything that influences the security selection in a way that obviates the processes that should define the construction planning and management of assets, is a material conflict of interest for those receiving advice. Where these payments are received they should be added back to the client's account.

Non monetary benefits

All these type of payments are inducements of a kind and while many may not necessarily have significance over short periods of time, they are intended to build up relationships that are themselves intended to influence product selection.

Leverage

According to the proposal, "The discontinuation of embedded commissions would also eliminate the incentive for representatives to potentially engage in unsuitable leverage strategies."

It is my opinion that the incentive to recommend unsuitable leverage would still remain and that a statutory best interest standard, with a fiduciary root, is required to address this issue.

Confusion over fee based arrangements

Evidence of the CSA's limited understanding of the importance of fee for advice based service process and confirmation of their implied intent to retain the product distribution frame comes with respect to their communications on fee based accounts.

> "There is also the possibility that some representatives may have less of an incentive to service clients after the initial sale were we to move to more widespread use of fee-based arrangements. This may lead to reverse churning"

> "Similar to the push toward online advisory services for investors with less than $100,000 to invest, it is possible that some "buy-and-hold" investors may be moved into fee-based accounts when transaction-based fees may be better for their circumstances (we note that this shift is already occurring today). We anticipate that the concept proposals outlined in CSA CP 33-404, if implemented, would limit this potential impact. As outlined above, there is also the potential for reverse churning in these arrangements"

These accounts are transaction volume discount accounts and are priced for optimising product and transaction distribution. That these accounts are the standard "fee based accounts" for much of the retail industry is another matter and a key reason why regulation needs to focus more on advice based service processes than supporting and refining the product distribution model.

Market competition issues

Independent firms, instead of being forced to compete on performance may well be forced to compete on distribution, compounding the product focus issues of Canada's retail financial services industry.

> "While we anticipate increased access to lower-cost fund products in the IIROC and independent MFDA platforms, we also anticipate that independent investment fund managers will still be at a disadvantage as they may not be able to gain access to those firms with closed, proprietary only, product shelves................"

> "investment fund managers may be required to set up a direct to client channel and obtain a dealer registration in order to compete in this space or alternatively, access these investors via a third party online advisory service"

> "For integrated dealers that choose to offer a closed shelf, as mentioned above, they would not feel the same level of pressure and would, at least initially, still be able to operate mostly as they do today, although as previously mentioned, the cost of the proprietary funds offered may fall"

> "Integrated firms as a whole would have more options, at least initially, to cross subsidize across both securities and non-securities business lines to maintain market share"

Canada needs a strong and vibrant independent financial advisor/er market place. While I see every reason to remove embedded commissions from retail financial advice I see no reason for forcing the independent sector to take the full force of imbalanced regulatory change.

Summary

The CSA seem to believe that the primary function of the advisory segment of the retail financial services industry is to transact and to sell products; if investors want advice, that is in their best interests, they should apparently head for the discretionary route.

> "The discontinuation of embedded commissions, along with any potential enhancements to the obligations of dealers and representatives and the growth of online advisory services, may also drive up the demand and the supply of discretionary management in Canada. This change is expected because these initiatives, along with the CRM2 initiative, may encourage dealers and their representatives to explain their value proposition to clients in a way many have never had to. In some cases, the easiest way for the representative to do this will be to show the client that the use of discretionary advice creates a savings discipline, simplifies their life and frees up their time."

Both discretionary and advisory platforms represent themselves as delivering personalised investment advice and both platforms exercise discretion over the processes through which they construct, plan, manage and communicate. The obligations and responsibilities of both channels in the delivery of personalised investment advice should be one and the same, a fiduciary type best interest standard.

The consultation on the option of discontinuing embedded commissions gives with one hand and takes with the other. On the one hand it looks to remove the obvious and necessary conflict of interest posed by embedded commissions on certain investment products, yet with the other hand it protects the sales conflicts associated with the largest and most dominant players in the market place. In this it expresses profound ignorance over the conflicts inherent in product distribution and the quite significant process differences associated with the provision of personalised investment advice.

The consultation is one of a long line of consultations that aims to provide greater rigour, clarity and discipline to the way in which products are distributed in the Canadian retail financial services market place while sidestepping the niceties of advice.

This is the Canadian way it seems, but it is one which poses serious risks to market competition and the development of best interest standards in the advisory segment, especially the independent sector, of retail financial services.

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