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Delivered by Email

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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 of New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon
Superintendent of Securities, Nunavut

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Me Anne-Marie Beaudoin, Corporate Secretary
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Dear Sirs/Mesdames:

Re: Proposed Amendments to National Instrument 81-105 *Mutual Fund Sales Practices* and Related Consequential Amendments - Comments of the Investment Management and Securities Litigation Groups of Borden Ladner Gervais LLP

We are lawyers in the Investment Management and Securities Litigation practice groups of Borden Ladner Gervais LLP and are writing this letter to the Canadian Securities Administrators to provide our collective comments on the above-noted amendments to NI 81-105 and related instruments. We provided our comments to the CSA on the CSA's previous consultation/discussion papers on mutual fund fees (2012 and 2017), as we have done on virtually every consultation and rule proposal that has affected the investment fund and asset management industry for the past 25+ years. Our comments should not be taken as the views of BLG, other lawyers at BLG or our clients.

BLG has been privileged to work with many managers of mutual funds and other investment funds operating in Canada and internationally for over 50 years. We have assisted in the structuring and establishment of hundreds, if not thousands, of mutual funds, and other types of investment funds. As such, we have seen first-hand the huge growth in the investment funds industry – not only in terms of its increased importance for investors, but also the increased sophistication of strategies, features and services associated with the various funds. We have also seen the significant rise in regulation and regulatory focus on investment funds. We often assist in industry initiatives, including those organized by The Investment Funds Institute of Canada (IFIC), the Portfolio Management Association of Canada (PMAC), and the Investment Industry Association of Canada (IIAC). Our lawyers participated in the working group that formulated IFIC's comment letter on the proposed amendments to NI 81-105, as we did with the previous papers on mutual fund fees.

We have also been privileged to work with many registered dealers (members of the MFDA and members of IIROC) and with many advisors, and understand their business models and successes, as well as the pressures (regulatory and operational) facing them in their work with Canadian investors to assist those investors to meet their financial objectives.

It is with this background that we provide the CSA with our collective comments and thoughts on the proposed amendments.

Comments on the Proposed Ban of the DSC Sales Option

1. Fundamentally our comments on the amendments to NI 81-105 have not materially changed from our comments on the 2012 and 2017 CSA papers. We support the decision by the CSA not to ban trailing commissions, however, we understand the CSA's policy rationale in respect of the proposed ban on the payment of trailing commissions to order execution only dealers, subject to our comments in paragraph 3 below. Ultimately, we continue to consider that the CSA have not made a case for banning "embedded commissions", which includes banning the DSC sales option as is proposed with these most recent proposed rule amendments.

   Our views on the proposed ban on the DSC sales option are informed by the following:

   a. As has been stated previously by many industry commentators, including during this most recent consultation, we consider the better approach is to reinforce the need for strong suitability assessments by dealers which recommend the DSC option to clients, as well as strong conflicts management by those firms in respect of the compensation received, rather than to limit choice for investors as to how they may acquire investment funds. In our view, allowing for investor choice, along with ensuring appropriate disclosure and compliance procedures should be the primary regulatory response to issues associated with mutual fund fees, as opposed to regulatory intervention and restrictions.

b. The notion that investors should be given the freedom to make their own investment decisions, provided that they have access to all relevant information and they are protected from fraudulent or improper practices that are not in the public interest, is a fundamental – and long-standing - tenet of securities regulation. As a general principle, the purpose of disclosure in securities law is to promote equality of opportunity and information for all investors in the market. The CSA have relied on this principle in crafting regulation that requires timely disclosure by the issuers, advisers and distributors of financial products in instances of material change, knowledge asymmetries and conflicts of interests. Disclosure of relevant facts is intended to allow the investor, when apprised of such information, to make reasonably informed investment decisions on a level playing field with other participants in the market. Disclosure must be sufficient to moderate any conflicts of interest inherent in fund managers paying dealers compensation and dealers accepting that compensation.

   As we pointed out in 2017, both the point of sale disclosure and the CRM requirements imposed by the CSA provide investors with complete disclosure of the costs and potential conflicts that arise when investing, as well as the potential benefits of such investment, so that investors may make an assessment of the relative risks and potential rewards. In our view, this should be sufficient, as opposed to an outright ban of DSC sales options, which substitutes regulatory opinion for that of investment professionals working with well-informed investors capable of making - and free to make - their own decisions about their investment options. In our view, investors should be encouraged to understand their investment options, which they can do working with a investment professional, rather than to have sales choices restricted.

c. As we pointed out in our 2017 submissions, the CSA proposals to ban the DSC sales options ignores the following:

   (i) With DSC and low load sales charges, 100 percent of the investor's cash is invested, whereas with front end load, the commission comes out of the initial investment, meaning less money is actually invested. Given the growing importance of ensuring sufficient retirement and other financial needs are met to all Canadians, greater investment in mutual funds should be encouraged by the CSA.

   (ii) With DSC and low load sales charges, if the investments are held for the prescribed period (which has shortened over the years and can be as low as 2 or 3 years), the investor pays no sales charges at all, which is consistent with the view of most fund managers that mutual funds are intended as long term investment vehicles.

   (iii) Front end load commission based sales can lead to more active trading in investment funds, which may result in churning of investments with a view to maximizing commission based income and a corresponding negative impact on the remaining investors in the funds.

2. If, notwithstanding the above comments, the CSA choses to proceed with its ban on the DSC sales charge options:

    a. It would be completely unreasonable to eliminate the right to collect redemption fees payable under DSC arrangements that were entered into in good faith by fund companies and investors prior to the announcement any new rules. This would interfere with contractual arrangements that were entered into in good faith and fail to recognize the funding obligations of the fund companies which are inherent in offering an investor the option of having all of the investor's money invested without the payment of a front-end commission. A flexible transition is necessary.

    b. There may also be a need for automatic switches of investors into another series once the redemption schedule has run its course, such as a front end load commission series, which may pay a higher trailing commission (which may not have been disclosed to the investor). These automatic switches should be permitted to be made seamlessly without the need for a fund, a fund manager or a dealer to incur the expenses of investor notices or fund facts delivery. We recommend that the CSA consider the issues carefully before making any rules and consult with the industry on operational issues like this, with a view to maximizing flexibility with little to no regulatory restrictions on how best to implement a DSC sales charge option ban. Whenever there is a need for a switch, fund facts delivery is an issue as noted above, as is appropriate disclosure in the simplified prospectus and we recommend that the CSA allow for flexibility.

Comments on the Proposed Ban on Trailing Commissions

3. We understand the policy rationale which led to the CSA proposing a ban on the payment of trailer commissions in the context of discount brokerage firms (OEO dealers). However, we consider that the CSA proposals (a complete ban of all payments) is a blunt regulatory tool that fails to take into account the nuances around sharing of the costs of distribution between fund managers, investors and OEO dealers. There are costs associated with operating an OEO platform – and generally speaking investors want low cost DIY solutions. It would increase OEO dealers' costs to charge clients directly for investing in mutual funds, including the costs of collecting such charges, which costs can be expected to be passed onwards by the OEO dealers to investors. Fund managers may wish to continue to pay some form of compensation to OEO dealers in order for their funds to be available on that platform. So long as there is sufficient disclosure of these payments and the payments are commensurate with the services being provided, we see no reasons for the CSA to ban series of mutual funds being available on an OEO platform where a lower trailing commission is paid to the OEO dealer in recognition that the OEO dealer provides a distribution service, for which it should be compensated.

4. We consider the CSA's continued portrayal of trailing commission as being payment for "advice" (which is not provided by OEO dealers) as being problematic. The payment of trailing commission by fund managers to all dealers has always represented more than simply a payment for "advice". It has represented a broader sharing of the costs of distribution, including infrastructure, compliance and operations. Particularly in the context of OEO dealers, the payment of trailing commissions is to compensate the OEO dealer for the distribution infrastructure that the dealer provides to fund investors. We respectfully point out that the CSA played a part in fostering the notion that trailing commissions are payment for "*advice and* services" when finalizing the point of sale "Fund Facts" regime, notwithstanding comments on this mischaracterization. We recommend that the CSA continue consulting on this issue, so they can understand why some form of trailing commissions may be appropriate in an OEO context.

5. The CSA also propose to ban the payment of trailing commissions by fund managers to dealers who "do not provide suitability assessments". This concept is overly broad and, in our view, is incapable of being reasonably implemented. If the CSA's concern is around OEO dealers, then we consider this concern should be articulated and specific rules made referencing only this channel. In most cases (if not all), fund managers are unable to determine which dealers provide "advice" (through suitability assessments) and which do not. This would put fund managers in a very difficult, if not impossible compliance position. Again, we believe that the CSA's decision to portray the payment of trailing commissions as being a payment for the provision of "advice" to be problematic and not reflective of industry realities.

6. We note question 9 in the CSA's consultation questions the necessity for dealers or fund managers to cause the investor to switch to another series if a ban comes into effect. We strongly recommend that a flexible regulatory approach be provided for in the final rules – one that does not impose Fund Facts delivery requirements for a switch of this nature, given that the need for a switch is due to regulatory intervention (the ban on trailing commissions).

BLG Response to CSA Questions related to Modernization of NI 81-105

7. We wish to respond to three of the questions posed by the CSA:

a. Question 12 - *Should NI 81-105 be consolidated into NI 31-103 (the registrant conduct provisions) in conjunction with the client focused reforms.*

NI 81-105 was written for a very specific purpose –to moderate the sales practices of managers and distributors of <u>public mutual funds</u>. As noted in the Companion Policy to NI 81-105, it was written with the benefit of industry input and was based on a draft IFIC code for sales practices that was generated in response to the discussion of sales practices in the Stromberg Report of 1995. While we agree that NI 81-105 could use a close review to modernize it and update it (perhaps expanding its reach to include other <u>public</u> investment funds), we strongly recommend that it <u>not</u> be subsumed into the client focused reforms. Even without the CSA moving the provisions of NI 81-105 into NI 31-103, we are concerned about the CSA's potential, which is hinted at, but not directly stated, to regulate the payment of trailing commissions through the client focused reforms (the conflict of interest provisions) notwithstanding the decision not to ban these payments. We recommend that the CSA ensure appropriate understanding of how they consider these provisions will operate in the context of the continued permitted payment of trailing commissions[1].

Moving the provisions of NI 81-105 into NI 31-103 is, in our view, unnecessary and at this time would be a potentially confusing and burdensome project.

b. Question 13 ***NI 81-105 only applies to prospectus qualified mutual funds – should it be expanded ?***

As noted above, NI 81-105 was written to regulate the sales practices of public mutual funds, in light of specific industry practices that had developed prior to its adoption. We consider it may be useful to consider expanding it to other public funds, but only after consultation and research into industry practices – and only in conjunction with a complete review and modernization of NI 81-105. It was not written for private pooled funds and should not be expanded at this time to cover pooled funds, unless the CSA consider (after carrying out research and consultation) that the same concerns about sales practices exist in respect of pooled funds, as for public mutual funds.

c. **Question 15** ***Should "principal distributors" be subject to the same rules as for participating dealers?***

The CSA specifically decided to set up a different regime for principal distributors of mutual funds (essentially dealers that distribute proprietary funds) than for participating dealers (dealers that distribute third party funds), given the fundamentally different relationships and the disclosure to investors about the relationships. The conflicts that NI 81-105 is designed to moderate around payments by fund managers to participating dealers, are not as apparent in connection with principal distributors. Any decisions to expand or change NI 81-105 in this area should only be done in conjunction with a complete review of its terms and provisions with a view to modernizing it. We do not recommend that changes be made piece-meal, particularly around the sales practice applicable to "principal distributors".

8. We point out that NI 81-105 has been the subject of considerable regulatory staff guidance, particularly from the Ontario Securities Commission. Much of that guidance is arguably in our view, OSC policy within the meaning of subsection 143.8(1) of the *Securities Act* (Ontario). However, none of that guidance has been subjected to a comment period, as is required for an OSC or CSA policy. Fundamentally, given the focus on compliance with NI 81-105 over the past several years and the degree of detail published by the OSC, not all of which we agree with, coupled with the OSC's stated expectations that industry participants follow that guidance, we consider that this guidance

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[1] Please see our comments in our letter of October 19, 2018 on the Client Focused Reforms – on the proposed Companion Policy discussion on the conflict of interest rules in section 13.4 of NI 31-103.

should be formulated into CSA policy and published for comment, and only finalized once those comments have been considered and taken into account.

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We hope that our comments will be considered positively by the CSA and as helpful to allow the CSA to make decisions as to amendments to NI 81-105.

We would also be very pleased to organize a meeting with the lawyers who participated in the preparation of this comment letter to discuss our comments further with interested CSA staff if this would be considered useful.

The following lawyers participated in the development of this comment letter. Please contact Rebecca Cowdery at 416-367-6340 (rcowdery@blg.com) if you have any questions or wish to convene a group discussion.

Whitney Bell, Jason Brooks, Rebecca Cowdery, David Di Paolo, Kathryn Fuller, John Hall, Lynn McGrade and Laura Paglia

Yours very truly,

Borden Ladner Gervais LLP

(Investment Management and Securities Litigation Practice Group Lawyers)