Backgrounder: CSA Consultation Paper 81-408 Consultation on the Option of Discontinuing Embedded Commissions

Introduction

The CSA has published for a 150-day comment period CSA Consultation Paper 81-408 – *Consultation on the Option of Discontinuing Embedded Commissions* (Consultation Paper). With the objective of enabling the CSA to make an informed decision about discontinuing embedded commissions, the Consultation Paper seeks input on:

- the potential effects on investors and market participants of discontinuing embedded commissions, including on the provision and accessibility of advice for Canadian investors, and business models and market structure;
- potential measures that could assist in mitigating any negative impacts of such a change, if a decision is made to move forward; and
- alternative options that could sufficiently manage or mitigate the identified investor protection and market efficiency issues.

Investor Protection and Market Efficiency Issues Raised by Mutual Fund Fees

Based on the evidence gathered, the CSA has identified three key investor protection and market efficiency issues stemming from the payment of embedded commissions:

- embedded commissions raise conflicts of interest that misalign the interests of investment fund managers, dealers and representatives with those of investors;
- embedded commissions reduce investor awareness, understanding and control of dealer compensation costs; and
- embedded commissions paid generally do not align with the services provided to investors.

Evidence also suggests that the conflicts of interest introduced by these payments are difficult to manage or mitigate.

To manage or mitigate these issues, the CSA believes that transitioning to direct pay arrangements must be considered. A change to this compensation model would:

- better align the interests of investment fund managers, dealers and representatives with those of investors;
- deliver greater clarity on the services provided and their costs; and
- directly involve investors in the dealer and representative compensation process.

Research that provides evidence for each of the key investor protection and market efficiency issues is summarized in Appendix A of the Consultation Paper.

Overview of the Proposed Option to Discontinue Embedded Commissions

The CSA contemplates that any regulatory proposal to discontinue embedded commissions would affect all investment funds and structured notes, whether sold under a prospectus or in the exempt market.

The CSA also anticipates that a discontinuation of embedded commissions would prohibit any payment of money to dealers in connection with an investor's purchase or continued ownership of an investment fund or structured note that is made directly or indirectly by any person or company other than the investor. It is expected that this change would at a minimum prohibit the payment by investment funds, investment fund managers or structured note issuers to dealers of the following embedded commissions:

- ongoing trailing commissions or service fees; and
- upfront sales commissions for purchases made under the deferred sales charge option.

The discontinuation of embedded commissions does not mean that dealers and their representatives would be expected to adopt fee-based compensation arrangements. Under direct pay arrangements, dealers and representatives could adopt various compensation arrangements, including upfront commissions, an hourly fee, a flat fee, a fee-based arrangement, or another suitable compensation arrangement, as long as the compensation is not embedded within the product and is paid exclusively by the investor.

The CSA also anticipates that investment fund managers could facilitate investors' direct payment of dealer compensation through deductions from purchase amounts or through periodic withdrawals or redemptions from investor accounts, with the investor's consent.

Potential Impacts of a Discontinuation of Embedded Commissions

Part 4 of the Consultation Paper outlines the CSA's assessment of the possible impacts of discontinuing embedded commissions based on an analysis of data on Canadian households and their ownership of funds and securities in general, and data on the investment fund managers and fund distributors that serve these households. Potential positive effects include:

- a reduction in fund series and in fund fee complexity;
- the entrance to the market of new lower-cost product providers and distributors;
- increased price competition and decreased fund management costs;
- a shift in product recommendations to lower-cost products, including passively-managed products;
- further market innovations in product distribution and advice; and
- better alignment between the costs investors pay for financial advice and the services and advice they receive from dealers and representatives.

The CSA's research suggests that the discontinuation of embedded commissions is not likely to lead to a significant advice gap for retail investors in Canada.

The consultation paper seeks input on potential negative effects of discontinuing embedded commissions on competition, market structure and investor outcomes.

Mitigation Measures

The CSA is mindful of the need to carefully consider and assess the unintended consequences that may result from the discontinuation of embedded commissions. Part 5 of the Consultation Paper discusses the potential unintended consequences identified at this stage.

To the extent the CSA may decide to move forward with a rule proposal to discontinue embedded commissions, the Consultation Paper aims to proactively identify and obtain input on various mitigation and transition measures that could help alleviate any negative impacts and unintended consequences of this change and successfully facilitate a transition to direct pay arrangements.

Ongoing and Recent Reforms

The CSA views the potential option of discontinuing embedded commissions as complementary to recent and ongoing reforms, including the Point of Sale disclosure and Client Relationship Model Phase 2 projects as well as the proposals to enhance the client-registrant relationship (CSA Consultation Paper 33-404 – *Proposals to Enhance the Obligations of Advisers, Dealers and Representatives Toward their Clients*).

Next Steps

The CSA welcomes feedback on the Consultation Paper, which includes 36 consultation questions. Given the broad potential impacts of the policy option discussed in the Consultation Paper, the CSA is holding a longer than normal comment period and is encouraging data-driven responses specific to the Canadian market. Comments should be submitted in writing on or before June 9, 2017.

To foster an open dialogue and facilitate additional feedback, in-person consultations will be held in 2017 in some jurisdictions.

The CSA reiterates the importance of the contribution of all stakeholders to enable it to make an informed decision on this matter and identify an appropriate policy response.