CSA/ACVM Canadian Securities Administrators Autorités canadiennes en valeurs mobilières

CSA Staff Notice 81-323
Status Report on Consultation under CSA Discussion Paper and Request for Comment 81-407 Mutual Fund Fees

December 17, 2013

Introduction

On December 13, 2012, the Canadian Securities Administrators (CSA or we) published for comment CSA Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees* (the Discussion Paper). This notice provides a summary of the key comments received on the Discussion Paper through the comment process and subsequent in-person consultations.

Background

The Discussion Paper identified a number of investor protection and fairness issues that may arise from the mutual fund fee structure in Canada. The issues we identified related primarily to the fees for advice, otherwise known as trailing commissions, that are embedded in the mutual fund fee structure, and included:

- investors' limited understanding of fund costs and control of embedded advisor compensation;
- the potential conflicts of interests that embedded advisor compensation gives rise to at the mutual fund manufacturer and advisor levels;
- the potential for cross-subsidization by a mutual fund's investors of the different advisor compensation costs associated with different purchase options;
- the alignment of advisor compensation and the services provided to investors in exchange; and
- the limited low-cost mutual fund options available to do-it-yourself investors.

The Discussion Paper solicited comments on a range of potential regulatory options to address these issues, including:

- defining the services that dealer firms and advisors must provide in exchange for trailing commissions;
- requiring the offering of a low-cost class of fund securities for do-it-yourself investors;
- unbundling the trailing commission component of the management fee and charging it to the fund as a separate asset-based fee;
- requiring a separate class of fund securities for each purchase option;
- capping commissions;
- implementing a best interest duty for advisors; and

- discontinuing the practice of advisor compensation being set by mutual fund manufacturers and embedded in the fund product.

We also stated our intention to consult with investors and industry participants to help us determine what, if any, regulatory responses might be appropriate. We received 99 comment letters from a range of stakeholders, including investors, investor advocates, mutual fund dealers, mutual fund manufacturers, industry advocates, academics, law firms and professional associations.[1]

Several CSA jurisdictions held consultations with stakeholders over the course of the Summer and Fall of 2013 in order to probe deeper into themes emerging from the comment letters.

The Ontario Securities Commission (OSC) held a public roundtable on June 7, 2013, featuring three panels with panellists representing investors, mutual fund manufacturers, mutual fund dealers and other financial industry stakeholders. The panel topics included:

- the role embedded advisor compensation plays in access to advice for small retail investors in the Canadian market;
- the nature and scope of the services received for trailing commissions; and
- the impact of current disclosure initiatives and whether regulatory action beyond disclosure is warranted at this time.

A transcript of the roundtable discussion is available on the OSC's website.[2]

The British Columbia Securities Commission (BCSC) held consultations with BC-based mutual fund dealers and mutual fund manufacturers on June 24 and 25, 2013. The Autorité des marchés financiers (AMF) held a consultation with retail investors on September 4, 2013, a consultation with both the Canadian Foundation for Advancement of Investor Rights (FAIR) and the Mouvement d'éducation et de défense des actionnaires (MÉDAC) on September 5, 2013, followed by consultations with mutual fund dealers, mutual fund manufacturers and other industry stakeholders on September 17 and October 3, 2013.

We thank all those who contributed to this consultation process by responding to our request for comments or by participating in the OSC, BCSC and AMF consultations. We are using the information we gathered through this process to inform our approach on this initiative going forward.

[1] The list of commenters and copies of the comment letters are available online at: http://www.lautorite.qc.ca/fr/consultations-anterieures-valeurs-mobilieres-pro.html.

[2] *Canadian Securities Administrators Roundtable Discussion re: Discussion Paper and Request for Comment 81-407 Mutual Fund Fees*, June 7, 2013 available at: http://www.osc.gov.on.ca/en/SecuritiesLaw_rpt_20130607_81-407_mutual-fund-fees-roundtable.htm.

Themes from the Consultation

We have identified a number of key themes emerging from the comment process on the Discussion Paper and the subsequent consultations. The themes are largely split between industry stakeholder viewpoints and investor stakeholder viewpoints.

The key themes from industry stakeholders are:

- There is no evidence of investor harm that warrants a change to the mutual fund fee structure in Canada;
- A ban on embedded compensation will have unintended consequences for retail investors and the fund industry, including:
  - a reduction in access to advice for small retail investors,
  - the elimination of choice in how investors may pay for financial advice, and
  - the creation of an unlevel playing field among competing products and opportunities for regulatory arbitrage; and
- We should observe and assess the impact of domestic and international reforms before moving ahead with further proposals.

The key themes from investor stakeholders are:

- Embedded advisor compensation causes a misalignment of interests which impacts investor outcomes and should be banned;
- Investors should at a minimum have the true choice to not pay embedded commissions;
- We need to implement a best interest duty for advisors; and
- We need to increase advisor proficiency requirements and regulate the use of titles.

Below, we discuss each of these key themes in detail. The themes underscore that the issues surrounding mutual fund fees are complex and that some of the issues are interrelated with those identified in the separate CSA consultation on the appropriateness of introducing a best interest duty for advisors initiated on October 25, 2012 (Best Interest Duty Consultation).[3]

a. Key themes from industry stakeholders:

1. There is no evidence of investor harm that warrants a change to the mutual fund fee structure in Canada

The vast majority of industry stakeholders express the view that there are no substantive regulatory problems in the industry that warrant the potential reforms discussed in the Discussion Paper. Only a marginal number of industry stakeholders believe the current mutual fund fee structure raises sufficient investor protection concerns to require regulatory action at this time.

[3] See CSA Consultation Paper 33-403 *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients* (October 25, 2012). See also the transcripts of the related investor roundtable, industry roundtable and panel discussion held June 18, June 25 and July 23, 2013, respectively, available at: http://www.osc.gov.on.ca/en/37838.htm.

Some industry stakeholders submit that the trend away from transaction-based sales commissions towards a greater reliance on embedded trailing commissions has supported the development of aligned advisory relationships between dealer firms/advisors and investors. Previously, advisors may have had an incentive to recommend that their clients switch funds in order to receive a sales commission. With trailing commissions, the advisor's interest are better aligned with the investor's objectives since the advisor's compensation is ongoing over the life of the investment and will increase as the value of the investor's portfolio goes up and decline if it decreases.

In response to claims that mutual fund fees in Canada are among the highest in the world[4], some industry stakeholders point to a recent research report comparing mutual fund ownership costs in Canada and in the United States which finds that, for investors helped by a financial advisor, the overall cost of management and distribution of mutual funds in Canada is similar to the overall cost in the United States.[5]

Some industry stakeholders submit that there is an absence of directly related research and empirical evidence that the conflicts of interest examined in the Discussion Paper exist at all or, to the extent they do exist, impact investor outcomes to a degree that warrants a complete overhaul of the mutual fund fee structure in Canada.

While some industry stakeholders acknowledge that trailing commissions have the potential to incent advisors to sell a particular mutual fund over another comparable mutual fund with lower commission, they submit that the incidence of such a conflict is minimal in the Canadian market since trailing commissions are largely comparable across types of mutual funds as a result of an open and competitive market. They believe that any variance from the current industry standard trailing commission of 1%[6] is small and unlikely to provide an incentive to offer one fund over another similar fund. In their view, this lack of disparity amongst trailing commissions suggests that competitive market forces are working well and that regulation is therefore not required. This view is however challenged by some mutual fund manufacturers who submit that the standard trailing commission of 1% has been established by an oligopoly of large dealer firms who command this fee to provide placement on their product shelf.

Certain industry stakeholders point out that the recent prohibition of conflicted advisor remuneration for the distribution of and advice on retail investment products in the United Kingdom (U.K.)[7] and Australia[8] are responses to unique consumer protection gaps and situations

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[4] These claims are based on studies examining fund fees in Canada and around the world, including: D. Phillips, *Why the trend in Canadian fund fees can only be down*, Morningstar Canada (August 13, 2013); B. N. Alpert, J. Rekenthaler and S. Suh, *Morningstar Global Fund Investor Experience 2013* (May 2013); B. N. Alpert, J. Rekenthaler, *Morningstar Global Fund Investor Experience 2011* (March 2011); J. Rekenthaler, M. Swartzentruber, C. Tsai, *Morningstar Global Fund Investor Experience 2009* (May 2009); A. Khorana, H. Servaes, P. Tufano, *Mutual Fund Fees Around the World* (July 23, 2007); and K. Ruckman, "Expense ratios of North American mutual funds", Canadian Journal of Economics (March 2003), p. 192-223.

[5] Investor Economics and Strategic Insight, *Monitoring Trends in Mutual Fund Cost of Ownership and Expense Ratios, A Canada-U.S. Perspective*, November 2012.

[6] Typical trailing commission for an equity fund sold on a front-end load basis.

[7] U.K. Financial Conduct Authority, *Retail Distribution Review - Adviser Charging*, rules in effect as of January 1, 2013.

in those jurisdictions, including a series of financial mis-selling scandals causing harm to investors, which are not present in Canada. They say it would be wrong for the CSA to follow suit with similar reforms as there has been no evidence of client harm arising from advisor compensation on mutual fund sales in Canada that would justify similar regulation here.

Some industry stakeholders say that less extensive regulatory changes could be made to help improve the Canadian retail investor experience. They suggest interim steps such as more vigorous enforcement of existing regulation (e.g. suitability requirements for advisors), enhanced proficiency requirements for advisors and the regulation of advisor professional titles to ensure that investors aren't misled by deceptive titles. They also call upon the CSA to undertake investor education initiatives in an effort to improve financial literacy and help investors become more savvy consumers of financial products and advice.

2. *A ban on embedded compensation will have unintended consequences for retail investors and the fund industry*

Overwhelmingly, industry stakeholders think eliminating embedded advisor compensation would be detrimental to all participants in the fund industry, including and especially retail investors. They urge the CSA, before doing anything, to conduct a robust cost-benefit analysis to determine the impact that removing embedded commissions would have for investors and the fund industry.

Many industry stakeholders believe a ban on embedded commissions would have a number of unintended consequences, including (i) a reduction in access to advice for small retail investors, (ii) the elimination of choice in how investors may pay for financial advice, and (iii) the creation of an unlevel playing field among competing products and opportunities for regulatory arbitrage. We discuss each of these potential consequences below.

(i) A reduction in access to advice for small retail investors

Several industry stakeholders submit that embedded advisor compensation provides Canadians with affordable access to advisory services. Many of them point out that these advisory services include not only the advisor's advice[9], but also important dealer firm services[10] and advisor operating costs[11], all of which are funded from the trailing commission. We are told that the

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[8] Australian Securities and Investments Commission, *Future of Financial Advice*, reforms in effect as of July 1, 2012, with compulsory compliance required from July 1, 2013.

[9] We are told that the portion of the trailing commission that the advisor receives compensates the advisor for the provision of various advice services, including but not limited to: suitability reviews, reviews on transfers, reviews of material changes in client circumstances, responses to client questions, general financial advice that can be unrelated to mutual funds, the rebalancing of portfolios, advice on registered products, the setting up of savings programs and the encouragement of good investment discipline.

[10] We are told that the portion of the trailing commission that the dealer firm receives helps fund the daily operation of the dealer firm's business. This includes satisfying client reporting obligations, general compliance obligations, supervision requirements, regulatory fees, operational costs and product due diligence.

[11] We are told that the portion of the trailing commission that the advisor receives does not operate solely as income for the advisor, but rather may also be used to cover the cost of administrative staff for which they are responsible, rental payments, marketing, travel, other costs of doing business, regulatory fees, and work associated with satisfying compliance obligations.

embedded nature of these costs enables advisors to provide up-front counselling to clients with small amounts to invest where a fixed fee or transaction-based commission model might otherwise deter clients from seeking advice.

These industry stakeholders submit that this affordability of financial advice has allowed for the significant use of advice by Canadian households, which certain industry studies find has resulted in the creation of a strong savings culture and investment discipline and the accumulation of more wealth for retail investors in Canada.[12]

Several industry stakeholders submit that smaller investors (sometimes referred to as "mass retail") benefit financially from the current embedded commission structure due to economies of scale. Under such a fee structure, the cost of providing advice and services to smaller investors is subsidized by the larger investors in the fund who pay more on account of their larger assets under management. We are told that the mandated use of a fee-for-service model would eliminate this pooling of fees from both larger and smaller investors and cause the price of servicing smaller accounts to increase. Faced with having to raise the price to service smaller investment accounts, many advisors would either cease to service those accounts or raise prices beyond which those investors would be willing to pay.

A number of industry stakeholders further submit that a mandated move to a fee-for-service model may impact the financial viability of certain advisors, especially independent financial advisors (as trailing commissions constitute the bulk of their revenues), and cause many to leave the business as a result. Such a change may also deter individuals from becoming advisors and consequently add to the industry's challenge in recruiting new advisors. We are told that this potential for a reduction in the number of advisors under a fee-for-service model, combined with the potential for higher costs for small retail investors, would cause those individuals to not be served and create an "advice gap".

Industry stakeholders further submit that small retail investors would lack the bargaining power to negotiate advisory fees in a fee-for-service model due to their generally low levels of financial literacy and the relatively small accounts they own. They would be at an information disadvantage as they would have no frame of reference as to what is reasonable. Consequently, small investors would be left with the choice of either incurring the potentially higher advice costs (including higher investment thresholds) imposed on them or, to the extent they are unable or unwilling to pay the costs, losing access to advisory services.

In support of their submissions, these industry stakeholders point to research suggesting that a fee-for-service model would result in higher advice costs and potentially higher overall ownership costs for small retail investors (i.e. those with less than $100K to invest) relative to the current embedded compensation model. Looking to U.S. data on mutual fund-centric fee-based advisory programs[13], some industry stakeholders suggest that advice costs for smaller

[12] See The Investment Funds Institute of Canada (IFIC), *The Value of Advice Report 2012*. See also C. Montmarquette, N. Viennot-Briot, *Econometric Models on the Value of Advice of a Financial Advisor*, The Centre for Interuniversity Research and Analysis on Organizations (CIRANO), Montreal, July 2012.
[13] Strategic Insight, *A Perspective on the Evolution in Structure, Investor Demand, Distribution, Pricing, and Shareholders' Total Costs in the U.S. Mutual Fund Industry* (November 2012), p. 35.

investors would be in the range of 1.5% of assets under management.[14] This would exceed what the fund industry submits is the current industry standard trailing commission of 1% embedded in the cost of the mutual fund product.

Some industry stakeholders cite research in the U.K. which finds that investors generally have a low willingness to pay a separate fee for financial advice and that most would not opt to use advice if they had to pay for it separately.[15] They further cite related research in Australia finding that there is a significant gap between what investors are willing to pay for advice versus what it costs to provide it.[16] Other industry stakeholders also point to early surveys on the impact of the ban on conflicted advisor remuneration in the U.K. as an indication that many advisors in Canada would either abandon small retail investors to focus on a higher wealth segment or leave the business altogether, and access to advice would be reduced as a consequence.[17] One industry stakeholder however points out that while there appears to have been an initial drop in the number of advisors in the U.K., this is in part due to a new proficiency standard introduced as part of the U.K.'s reforms and which some advisors failed to initially meet.[18]

(ii) The elimination of choice in how investors may pay for financial advice

Several industry stakeholders say that Canadian retail investors should have the option to choose among various fee structures and select the one they prefer. In their view, regulation should provide flexibility and facilitate the broadest access to financial advice for individuals.

Accordingly, industry stakeholders are of the view that investors should have the freedom to choose whether they want the convenience of paying for advice embedded in the cost of a mutual fund or paying it separately to their advisor. They point out that Canadian retail investors currently have this flexibility by way of being able to select either Series A fund units (that pay an embedded trailing commission) or Series F fund units (that do not pay an embedded trailing commission but instead provide for a negotiated fee-for-service to be paid directly by the investor to the advisor). They submit that prohibiting embedded advisor compensation would eliminate this flexibility and choice for investors, to their detriment.

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[14] According to analysis from Strategic Insight on advisory fees charged by client asset size under U.S. fee-based programs (2011), 70% of U.S. investors with account sizes of $100,000 are charged advisory fees higher than 1.25% and 31% are charged over 1.50%. *Ibid*, p. 34.

[15] A. Clare, *The Guidance Gap - An investigation of the UK's post RDR savings and investment landscape*, Cass Business School, January 2013.

[16] Australian Securities and Investments Commission, *Access to financial advice in Australia*, Report 224, December 2010.

[17] Deloitte LLP, *Bridging the Advice Gap: Delivering investment products in a post-RDR world*. November 2012.

[18] On August 15, 2013, the U.K. Financial Conduct Authority (FCA) released figures showing that financial advisor numbers in that country, which initially dropped with the coming into force of the Retail Distribution Review reforms which banned third party commissions and increased proficiency requirements, are now rebounding as more advisors meet the higher level of qualification. The FCA's research shows that there were 32,690 retail investment advisors working in the UK in July 2013, up from 31,132 in December 2012, the last time the numbers were officially counted. Six months after the introduction of the new rules, the FCA reports that 97% of advisors have the appropriate level of qualification, and the other 3% are recent entrants to the industry who are still studying for full qualification within the time periods permitted by the rules. See the FCA's press release at: http://www.fca.org.uk/news/adviser-numbers-in-line-with-expectations.

Many industry stakeholders submit that some investors specifically want to pay for advice through an embedded trailing commission as a matter of convenience and a matter of preference.[19] They go on to suggest that the current limited use of fee-for-service accounts by retail investors is evidence that investors are generally not interested in the fee-for-service model.

(iii) The creation of an unlevel playing field among competing products and opportunities for regulatory arbitrage

Industry stakeholders generally submit that mutual funds should not be unfairly targeted for having embedded commissions since advisor compensation is typically embedded in the prices (whether directly or through a spread) of other financial products, not just mutual funds.

Some industry stakeholders point out that embedded compensation is the standard in approximately three quarters of the total assets of all Canadian households, including deposits, fixed income, segregated funds, and insurance.[20] They say that to require mutual funds to move away from this widely accepted broader financial industry practice would create an unlevel playing field between mutual funds and competing financial products. Specifically, advisors who are dually licensed, and who already face greater regulation and compliance burdens in connection with the distribution of mutual funds[21], may have an incentive to instead sell banking and insurance investment products that some think are less regulated, less transparent, and possibly more expensive. Some industry stakeholders note that such opportunities for regulatory arbitrage have not arisen in the U.K. and Australia because their reforms[22] have been uniformly applied across competing products – securities, banking and insurance investment products.

Many industry stakeholders therefore urge the CSA to focus on initiatives that can be applied to the entire universe of financial products rather than solely target the mutual fund industry.

3. We should observe and assess the impact of domestic and international reforms before moving ahead with further proposals

Most industry stakeholders are of the view that if the main concern with embedded advisor compensation is that investors aren't aware of it and therefore don't understand it, then the solution should be to pursue initiatives that improve their understanding of such fees rather than focus immediately on prohibition. Accordingly, they think that the CSA should first assess the benefits resulting from the recent implementation of point of sale (POS) delivery of the new Fund Facts disclosure document[23] and the Client Relationship Model (CRM2) reforms to cost

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[19] In support of this submission, on September 30, 2013, the Investment Funds Institute of Canada published the results of a survey finding that half of mutual fund investors (51%) prefer their advisor be compensated through an embedded fee. See POLLARA Inc., *Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry 2013*, Report Prepared for the Investment Funds Institute of Canada.

[20] Investor Economics, *Household Balance Sheet 2012*.

[21] The industry points to the Client Relationship Model reforms (Phases 1 & 2) under *Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations*, and the new Fund Facts document delivery requirements under *Regulation 81-101 respecting Mutual Fund Prospectus Disclosure*.

[22] *Supra* notes 7 and 8.

[23] See the amendments to *Regulation 81-101 respecting Mutual Fund Prospectus Disclosure* made September 1, 2013 which, as of June 13, 2014, will require delivery of the Fund Facts document instead of the simplified prospectus in satisfaction of the prospectus delivery requirements under securities legislation.

disclosure and performance reporting[24], and determine whether these disclosure changes improve investor understanding and decision-making before proceeding with additional regulatory reform.

The POS and CRM2 disclosure initiatives are expected to benefit investors by improving their overall awareness and understanding of mutual fund fees and ongoing advisor compensation costs, thus enabling them to make better and more informed investment decisions. Those initiatives will also give advisors an opportunity to have conversations with their clients and to show how they add value. Many industry stakeholders say that the enhanced transparency that these reforms will provide should sufficiently address the potential conflicts of interest that embedded advisor compensation raises as well as improve the alignment between advisor compensation and the services provided.

These industry participants point out that they are investing significant resources to implement the POS and CRM2 reforms. They believe that once these are fully implemented, we will have set a world-class standard in Canada for disclosure and transparency of fund costs.

We are further urged to take the time to carefully monitor relevant international reforms, such as the recent ban on conflicted advisor remuneration in the U.K. and Australia[25], and assess whether those reforms caused unintended consequences for investors, in particular small retail investors, and industry participants in those jurisdictions before pursuing similar reforms here.

b. Key themes from investor stakeholders:

1. ***Embedded advisor compensation causes a misalignment of interests which impacts investor outcomes and should be banned***

Investor stakeholders generally think that embedded advisor compensation causes advisors to make investment recommendations that pay them higher compensation, resulting in higher costs and less optimal investment results for the investor. Most consider that this conflict of interest cannot be overcome through disclosure initiatives such as POS and CRM2 and consequently see no reason for the regulators to monitor and assess the effects of these or other reforms internationally before moving forward with a proposal to ban embedded compensation.

Most investor stakeholders therefore think that banning embedded compensation is necessary to reduce the misalignment of incentives currently affecting the client-advisor relationship and help assure investment recommendations that are in the best interest of the client. They say this ban would benefit investors by giving them greater awareness of and more control over the costs they pay for mutual funds and financial advice.[26] Investors will know that they pay for "advice" and will be able to compare the costs and services of different advisors as well as the operating costs

[24] See the amendments to *Regulation 31-103 respecting Registration Requirements, Exemptions and Ongoing Registrant Obligations* made July 15, 2013 which, as of July 15, 2016, will require registered firms to annually disclose to their clients the dollar amount of trailing commissions and other compensation they received in connection with securities owned by the client.

[25] *Supra* note 22.

[26] The AMF's consultation with retail investors revealed that most investors consulted were neither aware of the embedded commissions nor did they understand the fee structure of mutual funds.

of various mutual funds which will be made more transparent with the elimination of embedded compensation. This would lead to a more competitive market for both mutual funds and for financial advice, leading in turn to lower costs and improved returns for Canadian investors, thus enabling them to accumulate more savings for their retirement or other financial goals.

In response to industry participants' submissions that a ban on embedded compensation will reduce access to advice for small retail investors, investor stakeholders believe that if such an advice gap does indeed emerge, alternative fee structures or business models will develop, both within the existing institutions and through new entrants to the market, that will deliver advice tailored to small investors. Banning embedded commissions will lead to innovation and increase competition which will ultimately drive down costs for investors and improve their investment outcomes.

Certain investor stakeholders challenge the industry's "advice gap" argument by pointing out that a significant portion of small retail investors are currently serviced by the bank branch advice channel whose advisors are not commission-based. They therefore do not believe that eliminating embedded commissions would reduce access to financial advice for those investors.

Those investor stakeholders further question the industry's assertions that overall mutual fund ownership costs would increase if embedded commissions were banned. While not disputing the assertion that the cost of advice could be higher for small retail investors under a fee-for-service model, the absence of product embedded inducements under that model would allow the advisor to focus on the investor's best interests and shop the market for lower-cost products, resulting in overall cost savings and better financial outcomes for the investor over the long-term.

2. Investors should at a minimum have the true choice to not pay embedded commissions

Some investor stakeholders submit that, in the absence of an immediate ban on embedded commissions, retail investors should at least have the true choice to not pay embedded commissions.

These investor stakeholders dispute the industry's contention that retail investors currently have choice and that the prevalence of the embedded commission fee model in the Canadian fund industry is evidence that investors actually prefer that model. They submit that investors can only make a true choice if they know what the alternatives are and are provided with those options prior to actually making their decision. They point out that the majority of advisors today operate on a commission-only basis and therefore do not give their clients the option of investing in trailing commission-free Series F mutual fund units intended for fee-based accounts.[27] Furthermore, even where the option of investing in Series F units is available, many investors don't have the minimum investable assets necessary to access fee-based accounts. The overall result is that the majority of retail investors today have no choice but to invest in the full trailing commission fund units.

[27] The AMF's consultation with retail investors revealed that most of the investors consulted were not aware of the existence of Series F units.

Several investor stakeholders further point out that even those investors who opt to go it alone and forgo the advice still must pay for advice. This is because investors who purchase mutual fund securities through discount brokerages are generally made to purchase the same full trailing commission fund units that are sold through full-service advisors.[28] While discount brokerages receive full trailing commissions for the distribution of mutual funds on their platforms, they do not provide advice to investors who trade on their platform. Under the current rules, discount brokers are not permitted to offer advice and are exempt from the suitability assessment which full-service advisors are otherwise responsible for completing. In view of that, investor stakeholders submit that mutual fund investors in the discount brokerage channel are overpaying for their mutual fund investments and do not realize any savings over the investor who uses a full-service advisor. They further argue that if true savings could be realized in the discount brokerage channel, it might then become a true market choice that mutual fund investors would opt for. This lower-cost choice would improve retail investors' ability to accumulate savings for retirement or other financial goal.

These investor stakeholders therefore recommend that the payment of trailing commissions to discount brokers who provide execution-only services be prohibited. They further urge regulators to require that trailing commission-free mutual fund series be made available to retail investors, including at discount brokerages and directly from mutual fund manufacturers, to ensure that investors have the true option of not paying embedded commissions and that those investors who opt to do it themselves realize true cost savings.

3. We need to implement a best interest duty for advisors

Investor stakeholders strongly believe that advisors should be required to act in their client's best interest and that a statutory best interest duty must be introduced in order to protect investors. They point out that a best interest duty would be consistent with investors' general expectations, as shown by recent investor research that found that most investors believe advisors already have a legal duty to act in their best interest.[29]

In their view, a best interest duty which addresses issues relating to conflicted remuneration, including embedded commissions, will reduce bias in advisors' investment recommendations, thus making recommendations more objective. It would at the same time eliminate much of the need for conflicts disclosure, which investor advocates submit is ineffective. In this regard, they cite certain studies whose findings suggest that most Canadian investors do not have the requisite knowledge and experience to factor disclosed conflicts of interest into their decision-making.[30]

[28] The CSA note that following the comment process on the Discussion Paper and the subsequent consultations held by the OSC, BCSC and AMF, certain fund industry participants have taken steps to address this issue. Up until recently, only a few Canadian mutual fund manufacturers, all of which are bank-owned, have offered discounted series units of certain of their proprietary mutual funds through their affiliated bank-owned discount brokerage arm. These discounted series units intended for do-it-yourself (DIY) investors bear a significantly reduced trailing commission which recognizes the fact that DIY investors do not receive advice services. On November 27, 2013, three independent mutual fund manufacturers announced the offering of discounted series units of their mutual funds to be distributed through a major bank-owned discount brokerage.

[29] The Brondesbury Group, *Investor behaviour and beliefs: Advisor relationships and investor-decision making study*, (2012), prepared for the Investor Education Fund.

[30] Ibid. See also Innovative Research Group Inc., *2012 CSA Investor Index* (October 16, 2012).

They further cite behavioural research showing the perverse effects of disclosure, such as increased trust and reliance by investors and moral licensing of advisors.[31] Given these findings, investor stakeholders submit that a "disclose and move on" approach is not acceptable.

Investor stakeholders generally consider that a best interest duty for advisors would improve outcomes for investors because it would explicitly require advisors to consider the investment's costs in determining whether the investment is in the best interest of the investor, whereas the current suitability standard fails to require this.

Many investor stakeholders however submit that the current embedded advisor compensation model, with its inherent incentives, is incompatible with a best interest duty. They believe that absent the elimination of embedded commissions, the profit objectives of advisors and of the mutual fund manufacturers whose funds they distribute would continue to prevail over the best interests of investors. These investor stakeholders therefore think that a best interest duty alone is not sufficient and should include the concurrent elimination of embedded commissions.

4. We need to increase advisor proficiency requirements and regulate the use of titles

Some investor stakeholders submit that the investor protection concerns that embedded advisor compensation raise are compounded by other potential areas of concern with the advisor-client relationship, including confusing advisor titles and low advisor proficiency.

These investor stakeholders accordingly submit that financial advisors should be required to meet higher proficiency requirements and satisfy continuing education requirements, as well as adhere to a code of professional and ethical conduct that ensures the client's interest is put first. They further urge the CSA to standardize the professional titles and designations that advisors may use so as to ensure they more accurately reflect the scope of an advisor's services and do not denote expertise that the advisor may not have.

Some suggest that the use of the title "Financial Advisor" by a product salesperson, who is trained solely to deliver trade suitability rather than financial planning and/or ongoing investment management advice, has resulted in confusion and a distinct disconnect between the level of service many investors expect from their financial advisor and the actual service provided.

These investor stakeholders therefore submit that title and holding out restrictions should be put in place to allow the public to clearly distinguish between those who offer advice limited to trade suitability and those who provide more extensive advice and services, such as financial planning and/or ongoing investment management advice.

Conclusion

A number of the key messages from industry and investor stakeholders set out above are similar to those that have emerged from the Best Interest Duty Consultation. We refer you to CSA Staff Notice 33-316 – *Status Report on Consultation under CSA Consultation Paper 33-403: The*

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[31] Daylian M. Cain, George Loewenstein, and Don A. Moore, *"The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest"* (2005) The Journal of Legal Studies, 34(1), p. 1-25.

Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients, published concurrently with this Notice, for an overview of the key themes that emerged from that separate consultation.

The similarity of the feedback received from stakeholders demonstrates a connection between the two consultation initiatives and suggests a need for CSA staff to coordinate their policy considerations on these initiatives going forward.

Accordingly, in collaboration with the Best Interest Duty Consultation initiative, CSA staff continue to consider and discuss the information gathered through our consultative process with a view to determining next steps. We anticipate communicating in the coming months what, if any, regulatory actions we intend to pursue, including setting out research initiatives we intend to undertake to support such actions.

Questions

Please refer your questions to any of the following:

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