CSA Consultation Paper 81-408 – *Consultation on the Option of Discontinuing Embedded Commissions*

Registrant Outreach Session
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Overview

- Background on CSA Mutual Fund Fees review project
- CSA CP 81-408 consultation objectives
- Overview of CSA CP 81-408
- Next steps

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Mutual Fund Fees Review – Background

- CSA examination of fund fees began with CSA Discussion Paper 81-407 *Mutual Fund Fees* published for comment December 13, 2012;
  - Examined the conflicts of interest that embedded commissions give rise to for both (i) the investment fund manager (**IFM**) and the (ii) dealer firm/representative; and
  - Solicited comments on a range of regulatory options, including discontinuing payments from IFMs.
- Conducted in-person consultations in summer/fall of 2013.

Background (cont.)

- **Key industry comment:** Need to show evidence of harm to investors. Conduct research to determine if:
  - the misalignment of interests materially impacts investor outcomes; and
  - the alternatives to commission improve outcomes.

- CSA undertook research in 2014/2015:
  - **Brondesbury Group** – literature review - examined whether advice and investor outcomes vary depending on how advisor compensated; and
  - **Douglas Cumming** – empirical study - examined relationship between the payment of embedded commissions and fund flows.

Background (cont.)

- Research shows that embedded commissions are sufficiently problematic to warrant regulatory action;
  - Embedded commissions considerably reduce the sensitivity of fund flows to past performance – the greater the payment, the greater the level of net flows that is indifferent to past portfolio manager skill (i.e. alpha);
  - Funds that pay commission underperform;
  - Mutual fund distribution costs raise expenses and lower investment returns;
  - Higher embedded commissions drive mutual fund sales; and
  - Embedded commissions bias advisor recommendations toward higher commission generating products.
  - **Caution:** No empirical evidence that fee-based compensation improves investor outcomes.

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Background (cont.)

CSA conclusions from research:

- Embedded commissions encourage sub-optimal behaviour of both IFM and dealer/representative;
- Allocation of capital is distorted and investor outcomes are impaired; and
- Evidence strongly suggests a need to consider change.

Industry disagrees – submits discontinuing embedded commissions will lead to an '**advice gap**', particularly for lower-wealth investors.

- Industry evidence:
  - Value of Advice report (CIRANO); and
  - Experience of other jurisdictions (e.g. U.K.)

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Consultation objectives

- Published on Jan. 10, 2017 – comment period ends **June 9, 2017**.
- **Objectives:**
  - Assess potential effects of discontinuing embedded commissions on investors and market participants;
  - Identify potential measures that could assist in mitigating any negative impacts, if we move forward; and
  - Obtain feedback on alternative options.
- CSA requests '**new**' submissions that are:
  - Evidence-based/data-centric; and
  - Canadian focused.

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Part 2 – Key investor protection and market efficiency issues and related evidence (Appendix A)

1. Embedded commissions raise conflicts of interests that misalign the interests of IFMs, dealers and representatives with those of investors. Specifically, embedded commissions can:

    i. reduce the IFM's focus on fund performance, which can lead to underperformance;

    ii. encourage dealers/representatives to make biased investment recommendations at expense of investor interests; and

    iii. encourage high fund costs and inhibit competition by creating a barrier to entry.

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Part 2 – Key investor protection and market efficiency issues and related evidence (Appendix A)(cont.)

2. Embedded commissions limit investor awareness, understanding and control of dealer compensation costs. Specifically, embedded commissions:
    1. lack saliency which reduces investor's awareness of dealer compensation costs;
    2. add complexity to fund fees which can inhibit investor understanding of such costs; and
    3. restrict investor's ability to directly control dealer compensation costs and their effect on investment outcomes.
3. Embedded commissions paid generally do not align with the services provided to investors. Specifically:
    1. investors may not receive ongoing advice commensurate with the ongoing trailing commissions paid; and
    2. the cost of advice provided through embedded commissions may exceed its benefit to investors.

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Part 3 – Overview of proposed option to discontinue embedded commissions

- Potential discontinuation of embedded commissions would affect:
  - investment funds and
  - structured notes,

  whether sold under prospectus or in exempt market;
- Investors would enter into 'direct pay arrangements' under which would agree to pay dealer directly for services;
- 'Direct pay arrangements' would not require use of fee-based arrangements; and
- Investors would not be required to pay upfront – IFM could facilitate investor's payment through redemptions from account.

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Part 4 – Regulatory Impact

- CSA sets out it's analysis of the potential impacts of discontinuing embedded commissions - based on data compiled on:
  i. Canadian households in different wealth bands and
     - the extent to which they use advice;
     - the extent to which they hold investment funds, and
     - the type of distributor from which they purchased;
  ii. fund distributors (MFDA & IIROC channels) and extent to which they are independent or integrated; and
  iii. IFMs and extent to which independent or integrated.

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Part 4 – Regulatory Impact (cont.)

- Data shows:
  - **Majority of Canadian households do not own investment funds;**
  - **Lower use of investment funds by lower-wealth investors;**
  - **Cdn investment fund industry is dominated by major banks and insurers; and**
  - **High levels of vertical integration among both dealers and IFMs.**

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Part 4 – Regulatory Impact (cont.)

- Potential effects of discontinuing embedded commissions:
  - Rationalization of fund series / reduction in fee complexity;
  - Entrance of lower-cost providers;
  - Added price pressure on asset management costs;
  - Shift in dealer recommendations to lower-cost and/or passively managed products;
  - Shift in allocation of capital across active IFMs;
  - Market innovations - further growth in simple/lower-cost forms of advice (e.g. robo-advice); and
  - Significant ‘advice gap’ for lower-wealth investors unlikely.

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Part 5 – Mitigation Measures

- CSA suggests ways of potential impacts to investors and industry participants:

  - Allow IFMs to facilitate investors' payment of dealer compensation through redemptions;

  - Financial literacy initiatives to better equip investors to engage in negotiation of advice fees; and

  - Transition periods: e.g. 3 years or phased transition approach.

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Part 6 – Related Regulatory Initiatives and Existing Tools

- CSA considers extent to which existing regulatory tools and initiatives may address identified issues:
  - Point of Sale (POS) and Client Relationship Model (CRM) reforms;
  - Compliance review initiatives; and
  - Proposals to enhance registrant-client relationship under CSA Consultation Paper 33-404.
- Existing tools and initiatives may not on their own sufficiently address the issues because:
  - fundamental conflict is maintained;
  - may not sufficiently reduce fee complexity; and
  - may not sufficiently enhance competition.
- Consider that the discontinuation of embedded commissions would be complementary to existing tools and initiatives.

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Appendices

- Appendix A – Evidence of harm to investor protection and market efficiency from embedded commissions
- Appendix B – Other options considered but not retained
- Appendix C – International mutual fund fee reforms (U.S., U.K., Australia, New Zealand, Singapore, E.U., Netherlands, Germany, Sweden)
- Appendix D – Summary of consultation questions
  - 36 questions probe, among others:
    - Potential change in investor experience and outcomes;
    - Impact on level of industry consolidation or integration;
    - Potential challenges for independent vs. integrated dealers/IFMs;
    - Opportunities for lower-cost providers to enter market;
    - Potential for regulatory arbitrage;
    - Operational and technological impacts on processes at both IFM and dealer levels; and
    - Impact on revenue of dealers/representatives, on recruitment and career path.

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Next steps

- Consider comments received through written comment process – comment period ends June 9, 2017;
- Hold in-person consultations in early fall 2017 to facilitate additional input; and
- Make policy recommendation by end of 2017 or early 2018.

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Questions

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