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CSA proposed amendments to the principal distributor (PD) model
https://www.securities-administrators.ca/news/canadian-securities-regulators-propose-amendments-to-the-principal-distributor-model/

Kenmar appreciate the opportunity to comment on the regulation of Principal distributors and chargebacks.

Kenmar Associates is an Ontario-based privately-funded organization focused on investor education via articles hosted at www.canadianfundwatch.com Kenmar also publishes the Fund OBSERVER on a monthly basis discussing consumer protection issues primarily for retail investors. Kenmar is actively engaged with regulatory affairs. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused consumers and/or their counsel in filing investor complaints and restitution claims.

We were not aware of the NI81-105 carve out for this type of distributor and appreciate that the CSA has shone light on this cooperative arrangement.

The proposed amendments take a step forward to protect retail investors engaged with PDs. The amendments clarify that PDs can only work with one fund family, clarify that the DSC ban applies to PDs, provides a disclosure that asset managers share management fees with PDs for services provided and seek comments on potential regulatory action on chargebacks to address the significant conflicts-of-interest. The tough investor protection issues associated with restricted fund shelves that are highly publicized have yet to be addressed.

Given all that has been publicly reported on restricted product shelves, bank mutual fund sales practices and bank owned dealer use of proprietary fund's negative impact on the CFRs, we are disappointed with the limited scope of the consultation.

Despite our frustrations, Kenmar will nevertheless provide input to address the CSA consultation.

Comments on Consultation

Limit Principal distributors to distribution with one fund family

Eliminating the NI81-105 carve out for Principal distributors would be ideal but this action is not part of the consultation. **While the OSC considered banning Principal distributors, it concluded that a model where Principal distributors only distribute mutual fund securities of the one mutual fund family continues to have a place in today's mutual fund industry**, apparently even under CFR and empirical research showing the adverse impact on competition and investor retirement savings. We do not understand how this conclusion will allay the concerns expressed in the Ontario Minister of Finance's Letter of Direction https://www.osc.ca/sites/default/files/2021-11/Letter-of-Direction-to-the-Ontario-Securities-Commission-from-the-Minister-of-Finance-November-19-2021.pdf on this matter. [**The OSC response to the Letter was never made public]**

We are informed that the Proposed Amendments are aimed at providing mutual fund investors with increased investor protection and investor confidence in the capital markets from the proposal to have Principal distributors only distribute mutual fund securities of the same mutual fund family because there will be less conflicts of interest raised as compared to situations where principal distributors are distributing for multiple mutual fund families**.** It is estimated that there are just two Principal distributors in Canada that are acting for more than one fund family with a modest $27B AUM (estimated)-total mutual industry fund AUM $2 trillion approximately.

Ironically, the two PDs with two fund families can offer some choice to investors. If it turns out there is a PD with 3 fund families it could likely comply with CFR as long as its representatives made recommendations in the best interests of clients. It could very well be the second fund family brought some CIFSC fund categories to the shelf that could help construct more robust portfolios. The third fund family might focus on Alts which would help Dealing representatives better control risk-reward of the portfolio to suit the needs of more sophisticated clients.

On the other hand, restricting dealers to a single mutual fund family promotes accountability and reduces conflicts-of-interest.

Principal distributors should not exist in our view; associated issues are rarely explained in detail by the Dealer Representative. **They are a form of asset 'entrapment' by the institutions.**

Prohibition on redemption fees

This proposed amendment merely clarifies the ban on DSC funds. All managers have already ceased utilizing this toxic compensation scheme. We had actually thought the 2022 DSC ban had prohibited DSC across the full spectrum of the industry.

Disclosure

The Proposed Amendments require the simplified prospectus , Fund Facts and annual report on charges and other compensation to disclose that the Principal distributor has the exclusive right to distribute funds and if the Principal distributor receives a payment, other than trailing commissions, in connection with services provided to the fund manager and the funds as a Principal distributor, the maximum percentage of the management fee that is paid by the manager to the Principal distributor for its services. It is not clear what the services are.

The proposed disclosure reads:

"We have an exclusive right to distribute or a material competitive advantage over others in distributing the securities of [insert name of the fund]. [Insert name of fund manager] paid us up to a maximum of [insert percentage of the management fee] % of the fund's management fee for providing services as a principal distributor."

Kenmar tested the proposed disclosure clause on 15 Fund OBSERVER readers. Not one understood what the purpose of the clause was or how it would assist them in decision making. There was a suspicion that the disclosure was intended to warn clients of a conflict-of-interest between the Principal distributor and its clients. The conflict-of-interests between the PD and client should be explicitly stated in plain language.

Here are our thoughts relating to the recommended disclosure:

1 Clarify Objectives: The CSA should clearly articulate the purpose of this disclosure and how it supports investor protection or market efficiency.
2 Investor Testing: Conduct behavioral finance testing to evaluate how fund investors interpret and respond to the proposed disclosure language.
3 Avoid Promotional Language: Remove or revise the reference to a "material competitive advantage" to avoid misleading or overly promotional implications
4 Detail Payment Breakdown: Explain the non-trailer payment and how it differs from other forms of compensation, such as trailing commissions
5. Variable fee percentage: The disclosure should reveal that in some cases, the percentage payment may vary depending on the total level of assets under management attributed to the Principal distributor.

Fund Facts uses plain language based on empirical research of mutual fund investor literacy. A September 2022 OSC investor knowledge study found that investors have the least knowledge when it comes to investment costs and investor protections. In other words, literacy and high financial competency should not be

assumed for mutual fund investors in developing the disclosure. In our experience, most mutual fund investors don't know what they don't know.

We have seen materials from a restricted shelf Dealer that state:" *The breadth and depth of the [name of fundco] funds ensures that clients have the right mix of fixed income, balanced, domestic equity and international equity mutual funds to help them achieve their financial goals.* ".While this assurance may not be untrue, it could cause unsophisticated fund investors to believe there is no need to shop around. The shelf may be an adequate mix of asset categories but it almost certainly will not result in the optimum cost, risk or performance portfolio. Proprietary funds cannot be replaced for chronic poor performance because the Dealing representative has no other options. If a restricted shelf Dealer also employs Dealer representative chargebacks, the conflict-of-interests risks to retail investors are amplified.

A August 2023 CSA/CIRO CFR audit staff notice on conflicts-of-interest reported: " *Some firms we reviewed did not recognize that a registrant trading in, or recommending, proprietary products, is an inherent conflict of interest that is almost always material, given the potential for registrants to ignore clients' best interest. In addition, we found that firms that only trade in, or recommend, proprietary products, relied primarily on performing suitability determinations and providing clients with the conflicts disclosure to address these material conflicts of interest*. ***In our view, this generally will not be adequate to address these material conflicts of interest in the best interest of clients***" https://www.osc.ca/sites/default/files/2023-08/csa_20230803_31-363_client-focused-reforms.pdf#page7 If the Dealers don't recognize the conflicts and the conflicts disclosure is inadequate, something more has to be done.

Here is our suggested alternative disclosure clause that we think makes things a little clearer for retail investors:

"We have an exclusive right to distribute the [insert name of the fund]. [Insert name of fund manager] pays us up to a maximum of [insert percentage of the management fee] % of the fund's management fee for our services. This payment may present a conflict between our interests and those of our clients because the payments give us a financial incentive to recommend clients to buy those funds."

The disclosure of a conflict-of-interest should be explicit.

Even this disclosure may be inadequate to constrain aggressive selling. If the Reps are deployed to sell only mutual funds within the Principal Distributor's mutual fund family, these Reps cannot sell highly rated competitive mutual funds – they are at a competitive disadvantage. Hence, if the Principal Distributor only offers proprietary funds, its Dealer representatives will be disadvantaged because the only funds available for her/ him to sell may be inferior in costs, risks and/ or performance to competitor funds. This puts Reps in a difficult position to compete and/or comply with CFR regulatory intent. Perhaps this scenario explains the use of aggressive sales practices observed at bank branches.

CSA educational materials should warn retail investors about Dealers who offer only proprietary funds and the potentially adverse effect of limited fund choice on portfolio construction, cost, risk and performance.

Impact on retail investors

If the proposals are enacted, retail investors with accounts at a Principal Distributor representing more than one fund family will need to make changes to their mutual fund holdings. We assume no DSC charges would apply and transfers can be made to other Dealers. If the proprietary funds must be redeemed prior to transfer, unitholders will incur capital gains (or losses) and transaction fees.

Transferability of proprietary funds

In some cases we have found investors were unable to transfer proprietary funds to an account at another Dealer. In those cases investors had to redeem the funds and incur capital gains taxes (or losses) as applicable. **This possibility should be disclosed to investors prior to sale.**

Dealing representative title: We recommend that it would significantly enhance investor protection if PD representatives were limited to a title that made it crystal clear they face restrictions on what mutual funds they can *recommend e.g. XYZ Fund salesperson, XYZ Dealer representative.* ***Specifically, the Financial Advisor title should not be used.***

Chargebacks are evidence that advisors are in the business of sales, not advice (This is contrary to the CFR best interest standard.

In June 2023 the CSA announced it was concerned with chargeback conflicts of interest and was conducting a review. And here we are approaching 2025 with no action other than yet another consultation on the obvious. We cannot begin to express our frustration with this glacial speed of investor protection compared with the quick reaction the CSA takes to reduce industry "regulatory burden".

Similar to a DSC structure which was banned as of June 1, 2022, the chargeback model is predicated on clients maintaining their holdings for a set period of time. In this case it is the Dealing Rep that pays the early redemption penalty if redeemed before the fixed schedule expires. The inherent conflict embedded in the structure is that Dealer representatives would be incentivized to keep their clients in their holdings until the chargeback period has expired. This interferes with a Dealer's obligations to recommend and evaluate investment recommendations influenced only by the best interests of the client (a CFR obligation).

In effect, a chargeback compensation model reduces the chance that an unsuitable or underperforming fund will be recommended for sale. Having to repay part of the commission is a material conflict of interest. By recommending redemption, the Dealer representative would also need to explain that the recommendation didn't

work out or was unsuitable, an unlikely scenario. In several ways, chargebacks are worse for investors than the banned DSC sold mutual fund. A Dealer representative whose income is impaired is a Rep subject to *loss aversion*- the pain of a loss is far more painful than the joy of a comparable gain.

In addition, we believe it is fundamentally unfair for the Dealer to require return of commissions received by the Dealing representative if there are subsequent redemptions because the root cause of the redemptions may not have anything to do with the Rep. The redemptions may be due to poor performance of the fund, the availability of a low cost ETF, poor Dealer client service, mishandling of a client complaint etc.

It should be a no- brainer for regulators - ban chargebacks. Regulators focusing on advisor proficiency, ethics and client best interests should not permit these initiatives to be undermined by outdated Dealer Rep compensation schemes.

Conclusion

In our opinion, the NI81-105 carve out for Principal distributors should be re-assessed.

Retail mutual fund investors want and need product choice, trustworthy advice in their best interests and competitive fees. The intention of the client-focused reforms is to give investors access to products that best serve their needs -not to cause a move to Principal distributor proprietary funds .They are a form of asset 'entrapment' by the institutions.

Kenmar do not believe the proposed amendments are sufficient to materially retard the market share growth of Principal distributors, improve mutual fund competition or protect retail investors from the potentially harmful effects of restricted product shelves. Without enhancement, the proposed amendments will NOT achieve CFR regulatory intent. We have some ideas to enhance the proposed amendments and are eager to discuss them with you. [see attachment 1]

This consultation continues to support the distribution sales model rather than the professional fiduciary advice model. Unfortunately, unbiased professional mutual fund advice in Canada will remain elusive.

To the extent the CSA wants to protect retirement income security for Canadian investors, it is to that extent the CSA should prioritize dealing with the issues surrounding Principal distributors and restrictions on product shelves generally.

We hope the information provided proves useful to CSA decision making.

Please feel free to contact us if there are any questions regarding our commentary.

K. Kivenko, President
Kenmar Associates

cc Balance of CSA jurisdictions

ATTACHMENT 1

Investor Education: The CSA should communicate the issues related to in- house funds, the related conflict of interest and the impediments to transferability of proprietary funds between brokerages.

Titles: if proprietary funds are the only funds sold by a PD, the person recommending purchase must be titled *Fund salesperson, Dealer representative* or equivalent. The *Financial Advisor* tile should be prohibited.

Discussion prior to account opening: Principal distributors (PDs) should inform potential clients of the pros and cons of opening an account with them.

Fund comparators: Regulators should provide and proactively promote a investor-friendly fee impact calculator so PD funds can be easily compared to independent fund companies. This will illustrate the impact of fees on returns over the long term.

Disclosure: The material conflict of interest inherent in selling proprietary funds must be made in bold forthright language. Investor testing is essential.

Conflict-of-interest. Regulators must vigorously enforce rules and regulations with impactful fines and disgorgements.

Tied selling: Principal distributors should be prohibited from employing tied selling in the sale of securities including mutual funds. This must be enforced.

Fund Facts: Performance should be compared to a benchmark so investors can readily assess value for money.

Chargebacks: This method of salesperson compensation should be banned without delay. Such a scheme is an insult to CFR.

Use of index funds: Principal distributors should be encouraged to make available low cost index funds as integral to their shelf offering.

CSA research: (1) The CSA should conduct empirical research on the performance of proprietary funds vs. open funds for a number of categories (2) review Principal distributor sales practices and (3) review KYP practices employed by PDs.

CSA support of low cost investing: The CSA should foster ETF growth and enable discount brokers to provide a wide range of tools, calculators, model portfolios, research reports to permit confident DIY investing. This healthy competition will drive PDs to sharpen their business model.

CFR exemption: Unless fundamental changes are made, the CSA should consider granting a regulatory exemption to Principal distributors because a restricted shelf cannot in theory or principle claim to provide recommendations in the BEST interests of clients. Principal distributor marketing materials and disclosures would however need to align with the exemption.

REFERENCES

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Yet another 'review' of banks' sales practices. This is busy work and useless
https://www.theglobeandmail.com/business/commentary/article-yet-another-review-of-banks-sales-practices-this-is-busy-work-and/

Increase access to the shelf system for independent products: Morningstar
In a September 2020 comment letter to the Ontario Capital markets modernization Task Force , Morningstar pointed out that just six funds offer exposure to Global Small/Mid Cap equities from bank-owned asset managers, while there are 37 available from independent providers. Offering independent products in categories where few bank-owned funds exist would allow retail investors to gain exposure to asset classes through funds that may not be otherwise be presented as an option to the investor.
https://www.morningstar.ca/ca/news/205280/our-comment-letter-to-the-osc.aspx

Paul Chapman - The Wealth Management Industry's "Proprietary Funds" Problem: RBC WM
Flexibility, trust and investor empowerment is fundamental. These fund versions should not exist in my view, are misleading and are rarely explained in detail by the advisor.
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Ottawa reviewing big banks' decisions to stop selling third-party investment funds: G&M

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https://www.osc.ca/sites/default/files/2023-08/csa_20230803_31-363_client-focused-reforms.pdf#page7 See pg. 216 on how to address conflicts-of-interest for Firms who only deal in proprietary products