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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, New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
Superintendent of Securities, Yukon
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Re: CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions

I am pleased to be able to share my input (and that of our firm) on the above-referenced proposals. For background, HighView Financial Group is the brand under which we operate our business. HighView Asset Management Ltd. ("HighView") is registered in the category of Portfolio Manager in Ontario, Alberta, British Columbia, Manitoba and Saskatchewan. HighView designs portfolios for affluent families and institutions; embracing our status as a fiduciary and operating with diligent processes, transparency and robust – and clear – reporting.

GENERAL COMMENTS

I doubt that there is anyone in the industry that can justifiably deny the conflict of interest inherent in the structure of embedded compensation. While many dealing representatives conduct themselves professionally and like fiduciaries; I have seen first-hand how the conflicts of embedded compensation play out in advisor-client interactions and recommendations. This conflict was first highlighted in an Ontario Securities Commission research paper by Glorianne Stromberg[1]; succinctly captured in the following excerpt.

> *If a manager does not agree to increase the amount that it will pay by way of trailer or service fees to what a competitor is prepared to pay, the manager can expect that the sales representative will cause his or her clients to switch their investments to an investment fund group that will pay the higher amount regardless of whether this benefits the client or has tax consequences for the client. The payment of high trailer or service fees by an investment fund manager may also be a factor in a sales representative not recommending a change in the client's portfolio when it would be in the client's interests to make such change. This is why some people have referred to trailer or service fees as being "bribes" and why there is a high level of concern about the conflicts of interest that exist between the sales representatives and their clients.*

Remarkably, regulators and industry continue to discuss and debate this issue more than 22 years after it was first researched and documented. I note that I was part of a team that created an online suite of portfolio analytics in 1997 that created a level of transparency that is still beyond what CRM2 requires today. So I comment on this paper with a passionate interest in treating investors the way I would want to be treated – and with a history of taking action to achieve transparency for investors during my 23-year career.

While I have long thought that embedded compensation should not preclude full transparency for investors; the industry (product manufacturers and distributors) has done too little for too long in this respect. Now that it faces a full-blown ban on embedded compensation, the industry is responding with potential solutions. But I believe that it missed an opportunity. Accordingly, I agree that eliminating embedded commissions may be the only way to better align the interests of dealers and their clients.

[1] Recommendations For Regulating Investment Funds in Canada, Glorianne Stromberg, January 17, 1995.

What follows are my responses to the consultation questions, within which I've included my detailed comments on various aspects of this proposal.

CONSULTATION QUESTIONS

Part 2 (Investor Protection & Market Efficiency)

1. Do you agree with the issues described in this Part? Why or why not?

   Generally yes. The notion that embedded compensation create a conflict is intuitive; and supported by my anecdotal experiences. I note, however, that the paper authored by Dr. Douglas Cumming left me with many unanswered questions – even after directing many detailed questions to the lead author[2]. While I agree with the paper's conclusions I struggle to see how the data pointed strongly to this conclusion.

   For example, I am puzzled as to why the authors calculated flow-performance sensitivity using a series of stand-alone one-month periods. Intuitively, the impact of a material jump in trailing or deferred sales commissions would have to be measured over a period of at least several months – not a single monthly data point. Also, the paper's measures of flow-performance sensitivity used 'gross performance'. Given that fund distributors and sellers only 'see' net-of-fee returns I fail to grasp how they can be influenced by gross returns[3]. That said, I believe in the paper's conclusions because they are intuitive; I've seen this dynamic play out first hand over my 23-year career; and Glorianne Stromberg reached similar conclusions more than two decades ago after extensive research.

[2] I sent two emails to Dr. Douglas Cummings. The first was acknowledged but contained no replies to my questions. As of the date of this submission, I've received no response to my second email.

[3] I concede that strong gross performance is likely linked to strong net-of-fee performance but that depends entirely on the robustness of a fund's performance and the level of fees. It is seemingly more sensible to measure each fund series' performance directly – net of fees – since that is what distributors, salespeople and investors see.

2. Are there other significant issues or harms related to embedded commissions? Please provide data to support your argument where possible.

   None that come to mind.

3. Are there significant benefits to embedded commissions such as access to advice, efficiency and cost effectiveness of business models, and heightened competition that may outweigh the issues or harms of embedded commissions in some or all circumstances? Please provide data to support your argument where possible.

   I agree partly with the industry comment that eliminating embedded commissions is likely to result in advice becoming inaccessible to many people. But I have two related concerns that contrast with the broader industry's views.

   While I believe that eliminating embedded commissions will widen the so-called advice gap, I believe such a gap already exists. In my column for the mid-November issue of Investment Executive[4] I noted that IE's advisor survey figures suggest that even those that are already on the books as clients are unlikely getting the level of advice and service that they want and need. Still, I believe that eliminating embedded commissions will widen this gap materially. Online investment managers will fill some of this gap – but not all of it.

   An additional problem arises in the form of regulatory arbitrage.

[4] See http://www.investmentexecutive.com/-/advice-gap-exists-now

Advocis reports that the number of insurance-only licensed advisors grew from 19,460 in 2008 to 24,070 in 2011 – by far the fastest growing segment tracked by Advocis[5]. In a follow-up report, Advocis reported that insurance-based advisors grew 12% between 2010 and 2013 while the numbers of non-insurance licensed advisors fell slightly during the same period. These statistics support the suggestion in my March 17, 2015 article in the Globe and Mail[6] that some advisors are moving to the insurance platform to avoid tougher investor-friendly CSA regulatory changes.

Part 3 (Potential Scope of eliminating embedded commissions)

4. For each of the following investment products, whether sold under a prospectus or in the exempt market under a prospectus exemption – mutual fund; non-redeemable investment fund; and/or structured note – should the product be subject to the discontinuation of embedded commissions? If not:

    a. What would be the policy rationale for excluding it?

       These products are often sold alongside prospectus-sold mutual funds – by the same dealers and dealing representatives. So to the extent possible, any regulation that applies to mutual funds, should equally apply to these other exempt market products sold through retail distributors. There is one scenario in which I can see a strong argument to continuing to allow embedded compensation.

       Typically, all retail investment funds – i.e. mutual funds, ETFs, closed-end funds – see their management expense ratios rise with the addition or existence of a trailing commission. There are some instances, however, whereby a trailing commission effectively exists but it is paid by the product manufacturer – not the end investor or out of fund assets.

[5] See http://www.advocis.ca/pdf/Financial-Advice-Industry-Economic-Profile.pdf

[6] See http://www.theglobeandmail.com/globe-investor/funds-and-etfs/some-advisers-behaving-badly-with-crm2-on-the-horizon/article23511604/

For example, consider a fund with three series of units:

- Series A offers all of the traditional commissions to retail distributors. These units charge a 2% annual management fee, which includes a trailing commission of 1% per annum when sold on a front-end load basis.
- Series F has zero embedded compensation so its management fee is 1% per year.
- Series X also has a 1% management fee (like the F series). The fund's sponsor directly pays the dealer selling these units 0.5% per year as a trailing commission.
    - But in this case embedded commissions don't increase the management fee because the trailing commission is paid directly by the sponsor not out of fund assets. The sponsoring company effectively earns half of the management fee on this series in exchange for the dealer bringing it a large group of clients.

So in this case Series X units technically pay a trailing commission but it is not increasing the costs of the end investor (i.e. they're paying the F series fee rate). So I'd suggest writing definitions such that this kind of structure can survive even if this proposal is implemented.

b. What would be the risk of regulatory arbitrage occurring in the exempt market if embedded commissions were discontinued for the product only when sold under prospectus?

As it stands now, there will be some amount of regulatory arbitrage because none of the CSA regulations apply to distributors of insurance products – some of which look and sound similar to investment funds to end investors.

5. Are there specific types of mutual funds, non-redeemable investment funds or structured notes that should not be subject to the discontinuation of embedded commissions? Why?

   None that come to mind.

6. Are there other types of investment products that should be subject to the discontinuation of embedded commissions? Why?

   None that come to mind.

7. Do you agree with the discontinuation of all payments made by persons or companies other than the investor in connection with the purchase or continued ownership of an investment fund security or structured note? Why or why not?

   In theory, I don't fundamentally oppose the use of embedded commissions or third-party payments to compensate product distributors or dealers – as long as this is paired with meaningful transparency. Product manufacturers and distributors have proven that this has not been a high priority. As a result, they've not done enough to voluntarily create meaningful transparency. It's not hard to do. I've done it in a few different employment situations – starting as far back as two decades ago.

   While CRM2 can be evolved in a way that provides total cost disclosure – i.e. CRM3 – that is not enough. Investors not only need and deserve total cost disclosure through post-investment reporting; but it's also critical to provide accurate total cost estimates prior to investing so that investors can be fully informed prior to engaging a firm's services. And that is most efficiently accomplished in a regime where compensation is explicit – not embedded. Moreover, the industry has proven that true transparency will only materialize through new regulation – not voluntary innovations to create similar transparency.

8. Are there other fees or payments that we should consider discontinuing in connection with the purchase or continued ownership of an investment fund security or structured note, including:

   a. the payment of money and the provision of non-monetary benefits by investment fund managers to dealers and representatives in connection with marketing and educational practices under Part 5 of NI 81-105;

      I wouldn't lose any sleep if such payments are eliminated. Again the industry has been its own worst enemy by sometimes twisting NI 81-105 rules or breaching them altogether.

b. referral fees; and

There is no reason to eliminate referral fees so long as the relationship and the fees are clearly disclosed and explained – verbally and in writing – so that the end investor is paying the fee and is clear about what they're paying; to whom they're paying it; and what services is each party providing for the fees being paid.

c. underwriting commissions

These are key payments to facilitate capital raising – a vital function – so I'd recommend not banning these commissions.

Why? What is the risk and magnitude of regulatory arbitrage through these types of fees and commissions?

9. If payments and non-monetary benefits to dealers and representatives for marketing and educational practices under Part 5 of NI 81-105 are maintained further to the discontinuation of embedded commissions, should we change the scope of those payments and benefits in any way? If so, why?

Yes. While I don't have any specific recommendations in this respect, I urge the CSA members to review NI 81-105 with an eye toward aligning its provisions with the spirit of the final decisions that emerge out of this consultation process.

Product manufacturers have long had the flexibility to push the limits of such payments. And a recent Ontario Securities Commission settlement agreement[7] exposed how, despite the regulation, abuses can and will occur.

[7] See http://www.osc.gov.on.ca/documents/en/Proceedings-SET/set_20170331_sentry.pdf

10. With respect to internal transfer payments:

a. How effective is NI 81-105 in regulating payments within integrated financial service providers such that there is a level playing field for proprietary funds and third party funds?

Given that so few 81-105 enforcement actions have been undertaken – and none that I know of with respect to integrated firms – I don't have sufficient information to adequately answer this question.

b. Should internal transfer payments to dealers within integrated financial service providers that are tied to an investor's purchase or continued ownership of an investment fund security or structured note be discontinued? Why or why not? To what extent do integrated financial service providers directly or indirectly provide internal transfer payments to their affiliated dealers and their representatives to incent the distribution of their products?

Similar to my comments on potential changes to NI 81-105 I would take a similar view of internal transfer payments of organizations with affiliated product manufacturer and dealer subsidiaries. This consultation proposes to strip dealer compensation out of the product and make it transparent. Moreover, it proposes to end all payments to dealers from any party other than the dealer's clients.

In fairness and in keeping with the intent and spirit of the 81-408 proposals, it seems clear that internal transfer payments between affiliates of integrated firms cannot be tied to any product sale. Failure to take this measure would allow all integrated firms – particularly the big banks and insurers that already dominate Canadian wealth management – to have a product manufacturer compensate a related or affiliated dealer for product sales. And if the CSA moves forward to eliminate embedded commissions on investment funds and other products; it must similarly eliminate internal transfer payments for sales of the same products.

c. Are there types of internal transfer payments that are not tied to an investor's purchase or continued ownership of an investment fund security or structured note that should be discontinued?

None that I'm aware of.

11. If we were to discontinue embedded commissions, please comment on whether we should allow investment fund managers or structured note issuers to facilitate investors' payment of dealer compensation by collecting it from the investor's investment and remitting it to the dealer on the investor's behalf.

As long as the dealer in question has an account that it administers for its clients; this is a good interim step. Ultimately, however, the end goal should be to put this obligation onto dealers since they are the firm with the direct client relationship. And an interim step may be necessary given that dealers – particularly MFDA dealers – operate on thin margins.

Ultimately, however, I fully support a payment method whereby dealers can charge fees to clients' investment accounts. Allowing product manufacturers to facilitate the deduction and remittance of client fees opens up the potential for manufacturers to provide benefits to firms placing clients in their products.

In this case, manufacturers would not be paying a monetary benefit to dealers. But allowing them to facilitate fee payments – and remitting them to dealers – equates to providing a non-monetary benefit by saving distributors from the costs of setting up, maintaining and processing administrative and accounting systems for fee billing and HST remittance purposes.

However, allowing a product sponsor to facilitate fee payment and remittance for instances where a dealer is being compensated but does not administer a client account makes a great deal of sense. That said, full, true and plain disclosure is mandatory in this instance. Admittedly these instances are not the norm but they exist and should be considered by any implementation of this part of the proposal.

Part 4 (Potential Impact of eliminating embedded commissions on Stakeholders & Market Structure)

Addressing the issues

12. Based on a consideration of the data and evidence provided in this Part, would a proposal to discontinue embedded commissions address the three key investor protection and market efficiency issues discussed in Part 2?

    Yes.

13. Are there other ways in which the CSA could address these issues that could be introduced in conjunction with, or separate from, the discontinuation of embedded commissions?

    None that I'm aware of that are as simple and transparent.

14. Are there other conflicts of interest that could emerge following a transition to direct pay arrangements that would not be addressed in the current securities regulation framework?

    There is no such thing as a conflict-free method of advisory compensation. As I explained in a June 16, 2010 article[8] commission, asset-based, hourly and project fee models each have their own unique conflicts. There is no escaping the potential for conflicts of interest.

[8] See https://www.highviewfin.com/blog/advisor-compensation-no-fee-model-is-free-from-potential-conflicts/

Change in investor experience and outcomes

15. What effect do you think the removal of embedded commissions will have on investor experience and outcomes? In particular:
    a. Will investors receive advice and financial services that are more aligned with the fees they pay?

       I think this outcome is more likely but by no means assured.

    b. What effect will the proposal have on the growth of automated advice? Is this likely to be beneficial to investors?

       If you are referring to online investment managers (i.e. 'robo-advisors') then I expect that the proposal will spur growth of automated advice.

    c. Is discretionary advice likely to increase in Canada as we have seen in the other markets that have transitioned away from embedded commissions and, if so, would this shift be positive or negative for investors?

       This shift was already underway without a ban on embedded commissions. IIROC dealers have been seeing a gradual shift toward managed accounts with individual registrants registering as advising representatives. Others have left the dealer world behind to join or launch firms registered in the Portfolio Manager (PM) category.

       And the newest entrant – so called 'robo-advisors' – are registered PM firms. There are business and efficiency reasons explaining why this shift was already in motion. Moving away from embedded compensation may well accelerate this trend. That said, the shift won't be brisk given the differences in credentials and compliance.

    d. What effect will the proposal have on the growth of the online/discount brokerage channel and cost of fund products offered in this channel? Is this likely to be beneficial to investors?

       See my answers to 15 (b) and (c) above.

e. What effect will the proposal have on the cost and scope of advice provided to specific investor segments?

Given that a significant percentage of financial advice providers are licensed as dealing representatives (for securities purposes) and licensed to sell life and health insurance; clients with modest investment portfolios could still represent significant revenue.

To the extent that a ban on embedded commissions on securities would not preclude being able to still generate commission income from insurance sales, servicing clients with smaller investment portfolios can continue to be very economical. Most households have $100,000 or less in investable assets[9]. Some part of this majority – it's uncertain how much – will continue to be served by their existing (dual-licensed) representatives.

While the advice gap may widen, it's unclear to what extent and whether there will be shifts within this segment. For example, most households with assets of $100k or less do not currently use an advisor[10]. Some of those may be encouraged by the emergence of robo-advisors and make use of those services. Others who are currently receiving advice may opt out of the system after the dust settles post-implementation of this proposal (should that occur).

Also, it is my impression that there are more providers of pure financial planning advice compared to 10-15 years ago. Many are quite affordable and could also contribute to filling some of the advice gap.

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[9] Table 1, page 26, CSA Consultation Paper 81-408 – consultation on the option of discontinuing embedded commissions.

[10] Table 4, page 29, CSA Consultation Paper 81-408 – consultation on the option of discontinuing embedded commissions.

High Net Worth investors – generally those with $500,000 or more of investable assets – already have access to higher level services, discretionary management, and advisers that are legal fiduciaries. I don't anticipate this to materially change under a regime without embedded compensation.

16. What types of payment arrangements are likely to result if this proposal is adopted? In particular:

    a. Would the payment arrangements offered by dealers to investors differ based on investor segment? If so, how and why?

    No. The payment arrangement that strikes the best balance between efficiency and transparency is for advisory firms to charge the fee directly to each client's investment account. It's transparent because each statement will show fees paid in dollars; an aggregate amount of which will be disclosed at least once annually. And client directly pay fees to the firm from which they seek and receive advice. I cannot think of a reason to use different payment methods for different segments; other than the scenarios described in my responses to questions #4 and #11.

17. Do you think this proposal will lead to an advice gap? In particular:

    a. Which segments of the market are likely to be affected? Please consider segmentation by wealth, geography (size and location of community e.g. remote, small, medium, large), age, technological sophistication, the level of fund ownership across households, etc.

    See my response to 15 (e).

    b. Do you agree with our definition of an advice gap?

    Yes.

c. Should we differentiate between an advice gap for face-to-face advice and an advice gap generally?

Not unless that is a component of advice with which investors are unhappy. If that is the case, you could expand the definition of "advice gap" – e.g., investors who cannot obtain the amount of advice they desire at the price they are willing to pay and delivered through the desired mechanism (i.e. face-to-face, virtually).

d. What types of advice or services currently provided today would be most affected by the proposal?

I don't expect that this will change significantly. Higher net worth investors are more likely to receive more financial planning services; which I expect to continue. Most others are not receiving much financial planning; and I expect that to continue under a direct-pay regime.

e. Are there any potential interactions between this proposal, existing reforms such as CRM2 and other potential reforms such as CSA CP 33-404 that may affect the size of any potential advice gap?

It would be quite reasonable – if not recommended – for the CSA to consider and measure the impact of CRM2 prior to making a final decision on other pending initiatives, such as this proposal.

f. How could a potential advice gap, face-to-face advice gap or financial service gap be mitigated?

Most likely through full service firms adopting and implementing online platforms to service smaller accounts. Also with changing circumstances, I expect that dealers and other advice-providers will – out of necessity – innovate more efficient solutions for bridging this gap. The very existence and success of robo-advisors around the world is proof of just such an innovation. There are fixed costs to servicing and maintaining client accounts. Robo-advisory firms created a platform to make that much more efficient; though this efficiency only kicks in once sufficient scale is realized.

g. Do you think that online advice could mitigate an advice gap? If so, how?

Partially yes. Given that regulators have begun to work with online advisers to streamline profiling and onboarding for smaller accounts; the technological efficiencies will be an appealing option for many. But some advice gap will continue to exist – as it does today and has for some time.

h. Do you think that the significant market share of deposit-taker owned and insurer-owned dealers in fund distribution in Canada will affect the size or likelihood of an advice gap to develop?

No.

Industry change independent of regulatory response to discontinue embedded commissions

18. Given some of the changes we have seen in the industry over the past few years (fee reductions, introduction of DIY series, streamlining of fund series, automatic fee reductions increasing access to fee-based options etc.), what is the likelihood that the fund industry will transition away from embedded commissions without regulatory action? In particular:

a. Will the industry continue to transition away from embedded commissions if the CSA does not move forward with the proposal?

Some of the shifts toward lower fee series – such as the measures in question #18 – resulted from regulatory pressures as issues like Client Relationship Model, Best Interest Standard and this proposal were in various stages of discussion, proposal or implementation. The growth of exchange traded funds – and the participation in this segment by traditional mutual fund companies – resulted from a combination of competitive pressures and regulatory pressures.

While there have been pockets of price competition between investment funds, it was rarely widespread. Retail mutual fund companies were more likely – over the past two decades – to compete on commission rates than on fees. Indeed I witnessed this much more often than the few isolated examples of price competition. And price competition goes hand-in-hand with moving away from embedded commissions.

Most of the shift away from sales of deferred sales charge funds has been organic. CRM2 has likely all but killed what remained of DSC sales volumes. The uses of trailing commissions and, to a lesser extent, low load would continue without the implementation of this proposal.

19. How accurate is Figure 8 regarding the purchase options available to fund investors by channel, account size and firm type? In particular:

    a. Do you see payment options and business models evolving at present?

    Figure 8 appears accurate to me with one small exception. It is my impression that insurer-owned IIROC dealers serve a wider range of household account sizes than their bank-owned peers. As for payment options and business models; they are always evolving in response to and in anticipation of regulatory and competitive forces.

    b. How are they likely to change over time if the CSA were to choose not to move forward with the proposal?

    CRM2 would keep sales of DSC funds very low while trailing-commission-paying front end load sales option would remain prominent. But competitive forces and heightened standards – e.g., CSA proposed targeted reforms – would continue to nudge the industry away from embedded compensation. Also, discretionary platforms would likely become more prominent over time – thereby also raising the legal standard of care owed by most advice providers.

20. We note that the distribution of fee-based series is still relatively limited in Canada versus other markets. Are there obstacles (structural, operational, regulatory, investor demand, etc.) specific to Canada limiting the use of fee-based series by dealers?

    I can only speculate on these obstacles. One may be that many smaller or less sophisticated clients may be resistant to more explicit advisory fees. Another may be the limitations of back office and accounting systems required to support direct billing and the slow adoption of such systems due to the significant costs to acquire, set-up and maintain such systems. But these obstacles have been slowly abating over the past decade.

Potential impact on competition and market structure

21. Please describe how discontinuing embedded commissions will affect competition and market structure and whether you agree with the analysis set out in Part 4? In particular:

    a. Do you think the proposal will have an impact on the level of industry consolidation or integration? What about with respect to the concentration of mass-market investor assets held in investment products managed by deposit-taker owned firms?

       Consolidation of small-to-mid sized dealers has been occurring for many years – largely because thin margins and rising costs have necessitated greater operational scale. This proposal may exacerbate dealers' challenges and, in turn, accelerate or heighten this consolidation trend. Dealers may require even greater scale to offset the increased costs of complying with the Proposal and other new regulations (e.g., targeted reforms). Rising costs and increased need for scale will likely favour larger integrated firms and stifle competition to a degree. However, this proposal must be applied with fairness; in a way that treats independent and integrated firms equally.

b. What are the likely impacts on investor outcomes and market efficiency of any potential consolidation?

As noted fewer dealers equates to less competition; which generally does not bode well for investor outcomes. One example may be that less competition leaves less negotiating power in the hands of investors and more homogeneous pricing and services. Competitive forces will naturally offset this to some extent.

c. What opportunities and what challenges do you think the proposal would introduce for specific industry stakeholder groups?

i. Independent dealers?
ii. Independent fund manufacturers?
iii. Integrated financial service providers?
iv. Mutual fund dealers?
v. IIROC dealers?
vi. Online/discount brokers?

Small and medium sized dealers of all types (i.e. independent dealers, MFDA & IIROC dealers) will be challenged by a combination of increased costs and reduced revenue (from some client/asset attrition). These dealers are already challenged and this proposal will toughen their operating environment.

Independent fund manufacturers have been challenged to generate consistent inflows for some time due to increased competition – and dominance of banks – greater fee sensitivity (by advisors and investors) and disappointing performance. The long-term isolated impact of this proposal should be neutral; but shorter-term it will be a negative as both distributors and investors adjust to a new regime. There is a good likelihood that mutual fund assets will fall at discount brokerage firms, thereby adding to manufacturers' challenges.

Discount brokers will be hurt slightly as a result of lost trailing commission revenue. As of the end of 2011, discount brokerage client accounts held about 4% of total Canadian mutual fund assets[11]. At that time, this equated to mutual fund assets of about $33 billion. Assuming an average trailing commission rate of 30 basis points, that's nearly $100 million of discount brokerage commission revenue.

If this was spread across 100 or more brokerage firms, it would be a relatively small amount of revenue. But this amount is largely attributed to a handful of bank-owned discount brokers. So that is a significant revenue loss. I expect that discount brokers who continue to offer mutual funds trading on FundSERV will add their own fees to either make up the lost trailing commission revenue or to direct investors to securities with lower trading and custody costs.

Integrated firms like banks and insurers are the best positioned for a ban on embedded commissions. They have greater flexibility to modify compensation of client-facing representatives without technically tying it directly to product purchases; but where it can still reflect aggregate sales volumes.

d. What is the likelihood and magnitude of regulatory arbitrage across similar financial products such as segregated funds and deposit-taker products?

This is going to be a problem. Insurance-only licensees is the fastest growing segment of advice providers in Canada. I am convinced that the implementation of this proposal will foster more growth of insurance licensees; thereby exacerbating regulatory arbitrage.

[11] See pie chart on page 7 of http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_2012123_81-407_rfc-mutual-fund-fees.pdf

e. What would be the impact on dually-licensed mutual fund dealers and insurance agents?

Dually-licensed dealers[12] (and individual registrants thereof) tend to use CSA regulated securities for client investments while using their insurance licenses primarily to sell life and health insurance policies. In these cases there will be practical limitations to arbitrage different rules between securities and insurance registrations.

f. Will the proposal lead new, lower-cost entrants to the market? Why and how?

I do not see how this proposal will foster lower cost entrants. CRM2's disclosure of performance, compensation and charges – and the eventual evolution to total cost disclosure – is doing more to encourage lower cost products than a proposal to ban embedded commissions. As noted, the growth of the ETF segment has been accelerating for several years; unrelated to this particular proposal.

g. Does the interaction between this proposal and the proposals set out in CSA CP 33-404 change your responses to the questions above and, if so, how?

No.

h. Will a transition away from embedded commissions reduce fund series and fee complexity, as we have contemplated?

Yes. A lack of embedded compensation will eliminate the need for many of funds' series of units. It won't eliminate all series, as tiered pricing is still implemented via separate series of units. Also, I expect different series of units with a range of distributions policies will continue to exist. But this proposal will significantly reduce the number of series and FundSERV trading codes – which should reduce the operating expense component of product expense ratios.

[12] Many dealers have affiliated entities that are Managing General Agencies licensed to sell insurance policies.

i. Do integrated financial service providers have an advantage in terms of their ability to cross-sell and cross-subsidize across business lines? If so, how?

Yes. While tied selling is no longer employed, large integrated firms have made persuasive use of cross selling strategies. An example is granting more favourable terms on loans where investment accounts are transferred to the affiliated dealer.

j. What are the potential effects on competition of the rise in online advice? Are these effects likely to be large and positive?

Online investment advisers tend to have much smaller average account sizes compared to MFDA and IIROC dealers and other advisers. And despite early claims to disrupt bank and other dealer business models; it seems more likely that online platforms will partner with incumbents and leverage their physical reach to achieve growth targets. Overall these effects will be positive but online advisers may not be the competitive disrupters that many are expecting.

22. What impact will the proposal have on back office service processes at the investment fund manager or at the fund dealer? In particular:

a. Is there any specific operational or technological impact that we should take into consideration?

No comment.

23. The payment of embedded commissions requires the dealer and the investment fund manager to implement controls and oversight (with associated compliance costs) in order to mitigate the inherent conflicts of interest today.

a. Would the transition to direct pay arrangements alleviate the need for some of these controls and oversight?

Banning embedded commissions will not eliminate conflicts of interest; but they will reduce the number and extent of conflicts.

b. To what extent, if any, does the use of direct pay arrangements by representatives today (e.g. when a representative provides services under a fee-based arrangement) alleviate the need for some of these controls and oversight?

While a direct pay arrangement may alleviating some controls and oversight; it can also give rise to new ones. For example, auditing fee billing accuracy; having a process for flagging and correcting errors may result from dealers facilitating the payment of fees.

24. Embedded commissions, especially trailing commissions, provide a steady source of revenue for dealers and their representatives. If embedded commissions were discontinued, would dealers be able to compensate for the loss of this revenue with direct pay arrangements?

Yes. While it will require some client education efforts, reduced embedded product fees can be offset with direct charge percentage-of-asset fees roughly equal to the embedded commission. But this will be an administrative adjustment for dealers; a psychological adjustment for clients; and will require efforts by client-facing representatives to explain the change in – and comparison between – compensation structures.

25. Aside from commission grids and salaries, what other approaches to representative compensation might dealers use if we were to discontinue embedded commissions? How are these approaches likely to change over time?

I don't expect significant changes in compensation structure. Commissions will be replaced with asset based fees if this proposal is implemented; and salaries and grids will be a function of the fee generation of client-facing representatives.

26. What impact will the proposal have on representatives in the industry? In particular, what impact will the proposal have on the:

a. career path;

b. attractiveness of the job;

c. typical profile of individuals attracted to the career;

d. recruitment; and

e. relative attractiveness of careers in competing financial service business lines?

The industry has already undergone significant changes over my 23-year career. While it is more challenging today to start as a client-facing counsellor the industry, change is gradual. And this relatively slow speed of change allows industry, recruiters and potential candidates to adjust accordingly. I don't know how exactly this will change. But I know that if the right changes are made for the right reasons, all stakeholders will adjust and there will continue to be a need for the financial advice industry – hence jobs for hopeful candidates.

Part 5 (Measured to Mitigate Potential Impacts & Unintended Consequences)

27. How practicable are the mitigation measures discussed and how effective would these measures be at assuring:

a. access to advice for investors,

As your own research highlights, most with investable assets of $100,000 or less are not getting advice (be it due to lack of acceptable options or to choice). I don't expect that to improve materially on a net basis under the proposal. Nor do I expect the noted mitigation measures to help materially in this regard.

b. choice of payment arrangements for all investor segments, and

Choosing among a variety of payment arrangements is ideal but I no longer believe this to be feasible. Clients have technically had this choice for as long as I can recall. Yet the vast majority 'chose' commissions. But this was more of a passive choice than an active one. While some dealing representatives present a choice of compensation methods to clients; most do not. The vast majority of advice providers are compensated by commissions; the prevailing payment arrangement. This was not explicitly chosen by most clients. It was accepted when presented and explained. But survey after survey suggests that this was either not explained well or not well understood from the outset. So it's a stretch to call this a choice.

Since investors in fee-based accounts aren't actually writing a cheque for the fee – i.e. it is charged directly to the account – directly charged asset based fees can be considered somewhat passive. But greater transparency allows prospective clients to make a more informed choice; thereby injecting more accountability to the relationship between clients and their dealers and individual representatives.

The consultation paper makes a couple of references to hourly fees and flat fees as possible alternative direct pay arrangements. While this is theoretically true, these fee models are not feasible given the current industry structure, regulator and business environment. Unlike the legal and accounting professions there is no embedded demand for investment and financial advice. Quite the contrary, over the past two decades efforts have continued toward empowering individuals to take charge of their own investments.

Moreover, hourly fees are problematic in that it discourages contact between clients and advisor – or has the advisor doing a lot of work for free. Each outcome is far from optimal; but again does not align with the costs and legal responsibilities of administering and managing client accounts. Much of the same can be said of flat fees. The only fee model other than asset based fees that might work is a monthly retainer model. But any firm that adopts this model will likely have a tiered pricing model that is tied either to specific services or to household asset levels. In either case, prices will be set at levels that equate to asset based fees being charged today.

c. a level playing field amongst competing investment products?

Other than trying to convince other regulators to get onside, there isn't much that can be done to level the playing field across products falling under different rules.

28. What other measures should the CSA consider to mitigate the above unintended consequences?

I don't have specific suggestions at this time but always welcome the opportunity to discuss this issue in more detail.

29. Other than the potential impacts we have identified in Part 4, what other potential unintended consequences, including operational impacts and tax consequences, may arise for fund industry stakeholders and investors further to the discontinuation of embedded commissions? In particular:

a. Would there be a negative tax impact to investors associated with their payment of dealer compensation under direct pay arrangements? In particular, would the investor's payment of dealer compensation through periodic fund redemptions facilitated by the investment fund manager attract tax consequences? Please explain.

Yes it would. Direct pay fee arrangements – where fees are charged to client accounts – need not trigger negative tax consequences (e.g. taxes payable; additional reporting; higher tax filing fees). This is easily mitigated by holding small amounts of residual cash in each client account; having distributions paid in cash (to replenish cash); and periodically investing excess cash.

While this introduces some cash drag, it's minimal given the cash required. Charging fees by debiting each client's cash balance has no tax consequences. And the combination of cash distributions and periodic reinvestment keeps cash balances fairly steady. While this is easier to implement for discretionary accounts, a similar solution can be designed for non-discretionary accounts.

b. To the extent a transition to direct pay arrangements results in the rationalization of fund series, could this rationalization attract negative tax consequences for investors?

Yes, if funds are simply wound-up, liquidated and proceeds paid out. But I expect that the more common outcome would see investors in one series simply switched to another series within the same legal entity (i.e. mutual fund trust or mutual fund corporation). For tax purposes this is known as a reclassification of shares or units; and occurs on a tax-deferred basis.

c. What, if any, measures, regulatory or otherwise, could assist in mitigating potential operational and tax impacts?

See my answer to 29 (a) above.

30. With respect to the loss of a form of cross-subsidy from high net worth investors to lower-wealth investors in a fund further to a transition to direct pay arrangements,

a. to what extent (please quantify where possible) would the loss of this cross-subsidy increase the cost of providing advice and services to lower-wealth fund investors under direct pay arrangements?;

It's not a given that this loss would occur. Higher net worth investors are generally paying lower percentage fees (albeit higher in dollar terms) as a result of client demand for lower costs and competitive pressures. As I noted in my response to question #27 (b) even a retainer model would be tiered to reflect the additional work required for higher net worth households.

b. does the existence of this form of cross-subsidy suggest that high net worth fund investors may be indirectly paying fees that are not aligned with the services they are receiving (i.e. do the fees they pay exceed the actual cost of the services and advice they receive?); and

Every business prices its products and services above the cost of providing said products and services. This is the profit margin. Various regulatory measures and changes in the operating environment will see margins ebb and flow. And some client segments will be more profitable than others (though this depends on each firm's or representative's target market and services provided). But it is essential to the sustainability of every business to price its products and services at a level that allows for some profit margin.

c. what measures may mitigate the potential effects on dealers, representatives and investors from the loss of the cross-subsidy?

The continuation and evolution of tiered fee schedules will address dealers' revenue and profit needs while charging higher net worth clients lower percentage fees.

31. What measures could fund industry participants proactively take to mitigate the unintended consequences that may stem from the discontinuation of embedded commissions?

The industry has already been acting in this regard by lowering fees across the board, providing better pricing for large investments and by offering lower fee products for fee-based and discretionary platforms. In addition, launching ETFs has added to the lower fee products they now offer.

32. For each transition option, please tell us how your business (investment fund manager or dealer) would have to operationally change or restructure in terms of systems and processes and the related cost implications. Where possible, please provide data on the estimated costs.

    a. Are there unique costs or challenges to specific businesses?

       No transition necessary since our firm manages discretionary managed accounts on client's behalf; with fees charged directly to client accounts; and reporting with full transparency that is well ahead of regulatory minimum standards.

    b. What transition period would be appropriate?

       None; see answer to 32 (a) above.

    c. Should existing redemption schedules for DSC and low-load purchase options be maintained until the redemption schedule is completed, or discontinued at the Transition Date?

       Allowing existing schedules run their course seems reasonable.

33. Which transition option would you prefer? Why? Are there alternative transition options that we should consider?

    No comment.

34. As discussed in Appendix B, the CSA did not retain the option of capping embedded commissions, either as a stand-alone solution to the key issues discussed in Part 2 or as an interim step toward an eventual discontinuation of embedded commissions. Should the CSA further consider using a fee cap as a transition measure? Why?

    When commissions are embedded and are neither transparent nor negotiated, it can make sense to implement caps. But where fees are transparent and explicitly charged directly to clients; the industry should be free to let competitive forces decide organically fee levels that are acceptable to clients.

It is my hope that the CSA can find a way to engage the end investor in consultations like this – e.g., town hall and community outreach programs – particularly on an issue like this that so directly and significantly impacts them.

Otherwise I hope that you find my input somewhat helpful and informative. I remain, as always, eager to further discuss this issue with you as you review comments and consider next steps.

Sincerely,

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