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British Columbia Securities Commission
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 of New Brunswick
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island
Nova Scotia Securities Commission
Securities Commission of Newfoundland and Labrador
Registrar of Securities, Northwest Territories
Registrar of Securities, Yukon Territory
Superintendent of Securities, Nunavut

The Secretary Ontario Securities Commission
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Me Anne-Marie Beaudoin, Corporate Secretary
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Delivered via email to comments@osc.gov.on.ca and consultation-en-cours@lautorite.qc.ca

Re: Proposed Amendments to National Instrument 81-105 Mutual Fund Sales Practices and Related Consequential Amendments

I am again pleased to have an opportunity to provide input on the CSA's proposals pertaining to banning certain commissions and raising the standard required to resolve conflicts. For background, I am a principal with HighView Financial Group, a brand name used by HighView Asset Management Ltd ("HighView" or "HAML"). HAML is registered in the category of Portfolio Manager in Ontario, Alberta, British Columbia, Manitoba, and Saskatchewan. HighView is an investment counselling firm built around the concept of an outsourced chief investment officer (OCIO) for wealthy families and institutions. Accordingly, we are held to a legal fiduciary standard – which we openly embrace and promote – and have created true transparency in our communications and reporting to clients.

The above-reference consultation does not affect our firm, but we felt it important to participate in this and the previous consultation for the benefit of the broader industry and individual investors. I have personally spent the vast majority of my 24-year career advocating for higher standards.

The remainder of this submission consists of general comments on the proposals; responses to a selected number of the CSA's consultation questions; and some concluding remarks.

General Comments

Elimination of Deferred Sales Charge Commissions (DSC)[1]. I fully support the CSA's proposed elimination of all forms of DSC for mutual funds. Moreover, I support extending this proposal to other products and legal structures. In the early-to-mid 2000s linked note products that offered DSCs and trailing commissions that were well above market norms proliferated. They were not governed by any of the 81 series of investment fund national instruments that governed mutual funds.

They housed exotic and traditional strategies; had high embedded (often opaque) fees; and paid fat commissions to distributors. Simply focusing on mutual funds and not applying the same rules to products sold alongside mutual funds will create the incentive to create new product structures to get around the elimination of DSC funds. Less than 20% of mutual fund sales and assets are in DSC funds today[2]. Other regulatory initiatives (e.g. CRM2) and competitive market forces have been major factors in diminishing the prevalence of DSC fund sales. More than a few mutual fund executives have remarked to me that F-series units are seeing the bulk of fund inflows or are their fastest growing series.

The biggest industry argument against banning DSC is that it will create an advice gap and make advice unavailable for the average Canadian. But as I argued in my previous submission on this topic and in my November 2016 Investment Executive column[3] a significant advice gap appears to exist already. This is not surprising since the DSC mechanism was never created for any reason related to making advice available to more people.

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[1] My comments about DSC apply equally to variations of this structure – e.g., Low Load (LL) or Low Sales Charge (LSC) commission structures.

[2] Page 11 of https://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_20180621_81-330-status-report.pdf states that 21% of mutual fund sales and 18% of mutual fund assets were in DSC two years ago. Given the steady decline of DSC sales, I assume that DSC sales now account for less than 20% of all mutual fund sales.

[3] See http://www.osc.gov.on.ca/documents/en/Securities-Category8-Comments/com_20170609_81-408_hallettd.pdf and https://www.investmentexecutive.com/newspaper_/focus-on-products/advice-gap-exists-now/

It was created to benefit mutual fund sellers because of falling front-end commission rates on mutual fund sales; which once triggered high front-end loads[4]. Investor resistance to these commissions gradually drove front-end loads from 8%–9% to around 4%–5%; then to 1%–2%; and eventually to zero. The DSC structure was created in the midst of this decline – and was intended to preserve a generous up front commission for mutual fund sales – not to broaden or maintain access to advice. So the argument that preserving the DSC affects access to advice is baffling. Given all of this and the fact that even smaller MFDA firms now have fee-based platforms; I see no compelling reason to retain the DSC.

Another argument I have heard is that good behaviour can't be regulated. This is true but it doesn't mean that the regulatory regime should make it easy to misbehave. The MFDA conducted a review of compensation, incentives, and conflicts of interest in early 2016. They note, in its Compliance Bulletin #0705-C[5], that this review uncovered some extra incentives for selling specific funds – including proprietary funds. That such practices persist – in any magnitude – more than two decades after Glorianne Stromberg first identified and recommended the elimination of this practice is astounding and disheartening.

I see more long-term benefits than costs/downsides of eliminating this commission structure; which is still being abused (despite being in a long steady decline) and was created with a purpose of preserving up-front payments to distributors – not to benefit investors.

Elimination of Trailing Commissions to Order Execution Only (OEO) Dealers. I support this proposal without hesitation. I expect, however, that greater transparency – not reduced costs – will be the greatest benefit. That is a positive outcome but I expand on my reasoning below in my answer to consultation question #5.

[4] Front end loads were once as high as 9% of the gross purchase amount. On an investment of $10,000 for example; an up-front commission of $900 would be taken off the top and paid to the broker. The remainder – $9,100 in this example – would be invested in the chosen fund. This made front-end commissions as high as 9.89% ($900/$9,100) – which is also the percentage return required just to get back to the original investment.

[5] See http://mfda.ca/wp-content/uploads/Bulletin0705-C_2.pdf. In the past, the MFDA had seen significant use of leverage, many of the proceeds of which went into DSC mutual funds; particularly those that paid large (often unsustainable) return-of-capital distributions. This bulletin did not address any such strategies but some of the DSC assets surely fall into this category.

Resolve Conflicts in the Interests of Clients. This proposal sounds like a way to back into a best interest standard – but still falling short of a legal fiduciary standard. I'd like to see a full best interest standard given that advisors generally think they must hold client interests above all; and clients generally think that their advisors must meet this standard. Still, I support any measure to push the standard closer to a true fiduciary standard.

Selected Consultation Questions

Amendment of section 3.2 of NI 81-105

Proposed subsection 3.2(4) of NI 81-105 would prohibit fund organizations from paying trailing commissions where the participating dealer is not required to make a suitability determination in connection with a client's purchase and ongoing ownership of prospectus qualified mutual fund securities.

5. We expect that fund organizations will make available a trailing commission-free class or series of securities of a mutual fund to participating dealers who do not make suitability determinations. Would fund organizations have any issues with making available a class or series of securities of a mutual fund without trailing commissions to such dealers?

The issue is not with mutual fund manufacturers. If the law changes to preclude mutual fund manufacturers from paying any commissions to order execution only (OEO) dealers; I expect that they will gladly make a commission free series available through such dealers (e.g. F-series or equivalent). It's the OEO dealers that I expect will have a problem with this change. Six years ago – using figures contained in a CSA paper – I estimated conservatively that trailing commissions to OEO dealers totalled about $100 million per year. Since the big banks dominate the OEO dealer segment, that $100 million was split among a small group. If this revenue stream is eliminated I fully expect them to replace it with another direct fee that is based on some percentage of assets.

The launch of D-series fund units approximately six years ago was done in part because it was well known that CSA members frowned upon mutual fund manufacturers paying full trailing commission to OEO dealers. D-series units feature a 25 basis point trailing commission. This too would be eliminated under the proposal; but I expect OEO dealers to impose their own fees in an attempt to recapture this revenue.

Transition Period

We anticipate that a transition period of 1 year from the date of publication of the final amendments is sufficient time for registrants to operationalize the Proposed Amendments.

7. Are there any transitional issues for fund organizations and participating dealers with implementing the Proposed Amendments within the proposed 1-year transition period? If so, please provide details of the relevant operational, technological, systems, compensation arrangements or other significant business changes required, and the minimum amount of time reasonably required to operationalize those changes and comply with the Proposed Amendments.

With DSC fund sales making up a relatively small percentage of overall fund flows, any transition challenges are more likely to be isolated to specific individual representatives – not dealers. A material number of individual representatives continue to rely on DSC commissions for their income; but they are in the minority. The other transition issue is allowing time for existing redemption schedules to run off and expire over the next several years.

10. At this time, the CSA is allowing redemption schedules on existing DSC holdings as of the effective date of the Proposed Amendments to run their course until their scheduled expiry, and fund organizations to continue charging redemption fees on those existing holdings that are redeemed prior to the expiry of the applicable redemption schedule. Should the CSA propose amendments to require existing DSC holdings as of the effective date of the Proposed Amendments to be converted to the front-end load option or other sales charge option? If so, are there any transitional issues for fund organizations and participating dealers with converting existing DSC holdings to another sales charge option? What would be an appropriate transition period?

The terms of the sales of DSC funds required investors to pay a redemption fee to liquidate/switch-out of DSC fund units to other series of units prior to the expiry of the redemption schedule. I expect redemption charges to apply even if regulations require a quicker transition out of DSC fund units. In most cases, such switches do not result in lower management expense ratios (MERs) today. While it would be cleaner and quicker to transition sooner rather than later; the more practical measure is seemingly to let redemption schedules run their course.

Regulatory arbitrage

11. We understand that the elimination of the DSC option may give rise to the risk of regulatory arbitrage to similar non-securities financial products, such as segregated funds, where such purchase option and its associated dealer compensation are still available. Please provide your thoughts on controls and processes that registrants may consider using, and on specific measures or initiatives that the relevant regulators should undertake, to mitigate this risk.

My general comments above address this to some extent. Regarding the sale of insurance products, the ideal solution is to get insurance regulators to create rules and regulations to effect a harmonization of the regulatory regime for securities and insurance contracts that have primarily investment benefits. Practically speaking, that seems unlikely. The next best measure, in my view, is for dealers with dually-licensed representatives[6] to regulate insurance transactions in the same manner in which they regulate securities transactions. This is critical to ensure a consistent client experience.

Suppose a dually-licensed representative sells a mutual fund to a client. That sale comes with a set of regulations and reporting. A few months later, the same representative sells the same client a segregated fund; which doesn't require the same level of disclosure or reporting. But having previously purchased a mutual fund, the client will assume that buying another "investment" from the same representative at the same dealer would require the same disclosures and reporting. So it makes sense for dealers to regulate to the higher standard of care for all products sold by each representative. Admittedly, the specific implementation details would have to be worked out but this should be the end goal.

[6] This is where several representatives hold registrations to sell both securities and insurance products; and sell both types of products to clients.

Modernization of NI 81-105

After the implementation of the Proposed Amendments, the CSA may consider future amendments to modernize NI 81-105, an instrument that has been in place since May 1998. The following questions will help inform the CSA's initiative to modernize NI 81-105.

13. NI 81-105 currently applies only to the distribution of prospectus qualified mutual funds. In our view, the conflicts arising from sales practices and compensation arrangements that are addressed by the provisions in NI 81-105 are not unique to the distribution of prospectus qualified mutual funds and also arise in the distribution of other investment products, either sold under a prospectus or a prospectus exemption. Are there other types of investment products that are not currently subject to NI 81-105, such as non-redeemable investment funds, certain labour-sponsored investment funds, structured notes and pooled funds that should also be subject to NI 81-105? If not, why should these investment products, their investment fund managers and the dealers that distribute them, remain outside the scope of NI 81-105?

I agree that the goal should be to regulate products that are either mutual-fund-like; or that are sold alongside mutual funds by the same representatives in the same manner as mutual funds. See also my general comments and my reply to question #11 for more information.

14. We seek feedback on whether we should change the term "trailing commission" to a plain language term that investors would better understand and would better describe what a trailing commission is. If so, what are some suggested terms?

This is a good idea. My preference is for a term as simple as "ongoing annual commission" – or something similar.

Concluding Remarks

I happily participated in the OSC's September 2017 roundtable discussion on alternatives to eliminating embedded commissions. Much of the industry participation that day was seemingly aimed at protecting themselves with little regard for clients. This must change. I stated as much that day but it bears repeating. So I refer you to my blog post recap of that day[7]. In particular, I urged the broader industry – particularly dealers, dealing representatives, and mutual fund manufacturers – to focus on how each of them would want to be treated as clients of the industry; and focus efforts on creating feasible ways of delivering what clients need and deserve.

I also support the OSC in pushing back against the Ontario Minister of Finance. The Minister's statement opposing these proposals struck me as motivated by politics[8]; not by investor protection objectives.

Please feel free to reach out should you wish to further discuss this issue or any part of this submission.

Sincerely,

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[7] See https://www.highviewfin.com/blog/recap-of-the-osc-roundtable-discussion-on-discontinuing-embedded-commissions/ which recounts my perspective of the day of panel discussions.

[8] See https://www.highviewfin.com/blog/government-opposition-to-proposals-leaves-questions