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Consultation on the Option of Discontinuing Embedded Commissions

Background

On January 10, 2017, the Canadian Securities Administrators (**CSA**) released CSA Consultation Paper 81-408 – *Consultation on the Option of Discontinuing Embedded Commissions* (the "**Paper**"). The Paper concludes a multi-year review of embedded commissions in investment fund products. The 2012 Consultation Paper 81-407 – *Mutual Fund Fees* was the first time the CSA raised issues with embedded commissions. This set the stage for a roundtable in 2013 and several commissioned, independent research reports in the following years.

Investor Protection and Market Efficiency

The CSA believes that embedded commissions raise three principal investor protection and market efficiency issues:

1. Embedded commissions result in conflicts of interest that misalign the interests of investment fund managers (the "**Managers**"), dealers and representatives with those of investors;

2. Embedded commissions limit investor awareness, understanding and control of dealer compensation costs; and

3. Embedded commissions generally do not align with the services provided to investors.

The Paper also provides a list of sub-optimal behaviors linked to these investor protection and market efficiency issues:

- Investment fund managers rely more on payments to dealers than on performance to raise and preserve assets;
- Dealers recommend funds to clients based on the highest embedded commissions;
- Investors have no ability to manage or negotiate their dealer compensation costs; and
- Dealer compensation may not reflect the level of service the investor receives.

These concerns have led the CSA to conclude that a change to a different compensation model must be considered, but the CSA emphasizes that it has not made a decision to discontinue embedded commissions.

Conflicts of Interest

The CSA believes that the embedded commission model facilitates a conflict of interest by aligning the interests of Managers and dealers against those of investors. Specifically, embedded commissions reduce Manager's focus on performance, encourage dealers to make biased recommendations and encourage high fund costs while inhibiting competition.

The Paper suggests that Managers who pay embedded commissions to dealers may be incentivized to rely more on those payments than on generating performance to attract assets under management. Furthermore, the embedded commission structure may encourage Managers to erroneously regard the dealers as their customers. This inherent conflict of interest reduces the Manager's focus on risk-adjusted outperformance which impairs investor returns.

Embedded commissions may also incentivize dealers to recommend higher cost products that pay larger commissions or promote the use of certain purchase options that pay higher upfront commissions. This bias results in significant costs to investor outcomes.

The research also suggests that Managers compete to offer high embedded commissions to attract distribution which preserves higher overall fund fees and discourages the creation of lower-cost alternatives.

Limitations on Investor Awareness

The CSA believes that embedded commissions limit investors' awareness and control of dealer compensations. The CSA cites that embedded commissions reduce the transparency of compensation models, add complexity to fees that reduce investor understanding and restrict investors' ability to directly control costs in relation to investment results.

For example, the data clearly shows that the majority of Canadian investors are unaware that they are paying for financial advice because of the lack of saliency in embedded commissions. While dealer compensation costs are disclosed in the fund's prospectus, the variance in the fees, fund types, fund series and purchase options often overwhelm investors' capacity to understand the fees that apply to their investment specifically. Finally, since the cost of the dealer compensation is embedded in the fund's ongoing management fees, investors lack the ability to directly negotiate this cost and have no control over the amount they pay their dealer.

Lack of Paradigm Between Commissions and Quality of Service

The CSA also points out that there is no evidence that embedded commissions increase the quality of service or advice that dealers provide to investors. Thus, investors may pay for services from which they do not necessarily reap any benefits.

In summary, the CSA opines that embedded commissions encourage behaviour that negatively affects the fairness and efficiency of the capital markets and undermine investor protections.

Scope of the Proposed Ban on Embedded Commissions

The CSA emphasizes that it has not made a decision to discontinue embedded commissions and the purpose of the consultation is to consider the potential effects on market participants. The CSA's objective is to transition to a direct pay arrangement to better align the interest of participants and investors.

In the event that embedded commissions are discontinued, the CSA anticipates that such regulation would affect "investment funds" and structured notes, whether sold under a prospectus or an exemption. The term investment fund, as defined under securities legislation, would capture conventional mutual funds, ETFs and non-redeemable investment funds. However, segregated funds would not be captured in any CSA rule and the CSA plans to liaise with insurance regulators to address potential arbitrage.

Any proposed rule would prohibit third party payments to dealers in connection with the purchase or continued ownership of a security.[1] This prohibition would effectively prohibit ongoing trailing commissions or service fees and upfront sales commissions for purchases made under a deferred sales charge structure.

The proposed rule would not prohibit other compensation options such as upfront commissions, hourly fees or flat fees, as long as the dealer and investor agree to the rate and structure in writing.

Furthermore, the following types of compensation are likely to be permitted:

- Referral fees;
- Dealer commissions paid out of underwriting commissions on a distribution that is not continuous under an IPO;

[1] In other words, the rule prohibits payments made directly or indirectly by anyone other than the investor.

- Payments or non-monetary benefits by Managers to dealers in connection with marketing and education practices under NI 81-105; and
- Internal transfer payments from affiliates to dealers within integrated financial service providers.

The CSA states that it will only proceed after an assessment of possible impacts not previously raised.

Consequences

The Paper provides a summary of the known impacts of a proposed ban on embedded commissions, but with a large focus on the benefits. The impact summary also assumes that current details about the market hold and that the new Client Relationship Model (**CRM**), Point of Sale (**POS**) and the proposal for the best interest standard and targeted reforms ("**Best Interest**"**)** regulatory initiatives are fully implemented.

Overall Market Impact

The CSA believes that a prohibition on embedded commissions would significantly reduce the number of fund series available in Canada since many of these funds differ only by the type of embedded compensation. A prohibition would also reduce the barriers to market entry, giving way to new lower-cost product providers to enter the mutual fund market. This expected increase in competition would also encourage dealers and Managers to focus on fund performance and fee reductions.

The CSA assumes that with the introduction of a new rule, actively managed funds producing negative alphas may be at risk over time. A new rule is also expected to increase market innovations, including increased access to online advice, automation, and focus on value propositions. The CSA does note that innovations and market shifts could potentially drive up the cost of advice as evidenced in the United Kingdom.

In summary, the CSA anticipates the following effects on the market:

- Reduction in fund series and in fund fee complexity;
- New lower-cost product providers entering the market;
- Increased price competition / decrease in fund management costs;
- Shift in product recommendations to lower-cost or passively managed products;
- Shift in assets across existing investment fund managers; and
- Market innovations in product distribution and advice.

Impact on Investors

The CSA believes that fund ownership by mass market investors[2] will grow sizably following a ban on embedded commissions. However, the CSA also realizes that some independent fund dealers may choose not to service mass market households. This has the potential of creating an "advice gap" where investors cannot obtain the advice they desire at the price they are willing to pay. It is expected that a prohibition on embedded commissions would largely benefit mid-market investors[3] while not significantly affecting affluent investors[4]. Finally, the discontinuation of trailing commissions would significantly lower the costs for "Do-It-Yourself" investors.

Impact on Independent Investment Fund Managers

The anticipated effect on Managers is a decline in fund management costs and an increase in lower-cost, passively managed funds. The CSA estimates that some actively managed fund assets will be at risk of redemption pressure. Also, Managers with a large proportion of negative alpha funds would likely face additional challenges such as fewer cross-subsidization options.

[2] Mass market investors are those investors with investable assets below $100,000.

[3] Mid-market investors are those investors with investable assets between $100,000 and $500,000.

[4] Affluent investors are those investors with investable assets above $500,000.

A prohibition on embedded commissions could also allow high alpha generating Managers better access to the IIROC and MFDA channels as fund performance will become a more important driver of fund flows.

Independent Mutual Fund Dealers

The anticipated effect on independent mutual fund dealers is an increase in competition for the level of service and advice because of automated solutions. Some independent dealers may face difficulties in maintaining assets if they cannot explain their value proposition to investors.

Integrated Financial Service Providers

The CSA believes that a prohibition on embedded commissions would put pressure on asset management divisions of integrated financial service providers to reduce their pricing structures. This will likely result in the marketing of low-cost, passively managed fund options. However, the pressures on these firms will likely not be as high as that of their independent Manager counterparts.

Mitigation

The CSA recognizes that a transition to direct pay arrangements is a significant policy change and may have unintended consequences for both investors and the fund industry. Examples include a reduction in access to advice for lower-wealth investors and the elimination of choice in how investors pay for financial advice.

The Paper suggests that some of these impacts could be alleviated by innovations in technology, including the prevalence of online and automated advice. The impact of any unintended consequences could also be alleviated by allowing Managers to collect payments from the investor’s investment and remit them to the dealer on the investor’s behalf.

Additionally, the CSA is reviewing two transition period options to mitigate the burden on fund participants:

- Transition within a defined transition period; or
- Transition by account.

The first option contemplates a transition period of 36 months after the effective date of the proposed rule. The alternative is to require transition based on account base over multiple periods. Under this latter option, dealers would need to transition percentages of their accounts by certain dates until all accounts have been fully transitioned.

Other Regulatory Initiatives

Market participants have noted that the concerns raised by the CSA have already been addressed in other regulatory initiatives such as CRM, POS and Best Interest. However, the CSA believes that these other reforms serve other objectives and will compliment a prohibition on embedded commissions.

For example, the CSA acknowledges that both the POS and CRM initiatives assist in reducing conflicts of interest by enhancing disclosure, but disclosure alone falls short of fully addressing conflicts raised by participants' incentive to maximize revenue over client interests. Additionally, enhancing disclosure does not address the complexity of the fund fee structure which impedes investors' understanding of compensation costs.

Other Jurisdictions

While the Paper provides commentary and analysis on the effects of a prohibition on embedded commissions in other jurisdictions, the CSA believes that the impact in Canada would differ.

United Kingdom

In 2012, the U.K. introduced rules under the Retail Distribution Review (**RDR**) to raise advisor qualification levels, improve transparency of fees and services and realign advisor incentives with those of consumers by removing commissions received from product providers.

Specifically, the rule on commissions requires advisors to explicitly explain fee arrangements in agreements with clients and prohibits commissions from product providers or commissions otherwise embedded in the cost of the product.

Post implementation, the RDR has reduced product bias as reflected by the decline in the sale of products which paid higher commissions. The regulation has also led to a significant increase in sales of, and assets held in, index tracking funds. Furthermore, competition has increased and product costs have decreased. The RDR has also had certain drawbacks including increased advice costs for investors, increased focus on higher-wealth clients and an advice gap for lower-wealth investors.

Australia

Australia introduced the Future of Financial Advice Reforms in 2012 which prohibited upfront and trailing commission, among other things.

The results of the regulation have been relatively uneventful, but there is evidence of an increase in the cost of advice.

European Union

The E.U. regulations came into force in 2014 and must be adopted by member states by 2018. The regulations, among other things, prohibit independent advice or portfolio managers from accepting any fees, commissions or monetary benefits in relation to the advice or service. Compensation from third parties is permitted if it is passed through to the client entirely and not retained by the investment firm. Commissions on in-house products are still allowed provided that the firm complies with its fiduciary duty to its clients and such fees are clearly disclosed.

These regulations are set to apply in 2018, and therefore the impact remains to be seen.

Next Steps

The CSA invites all participants to provide feedback until **June 9, 2017** and the Paper provides respondents with a series of questions to consider when responding. Certain jurisdictions will also conduct in-person consultations.

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a cautionary note

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